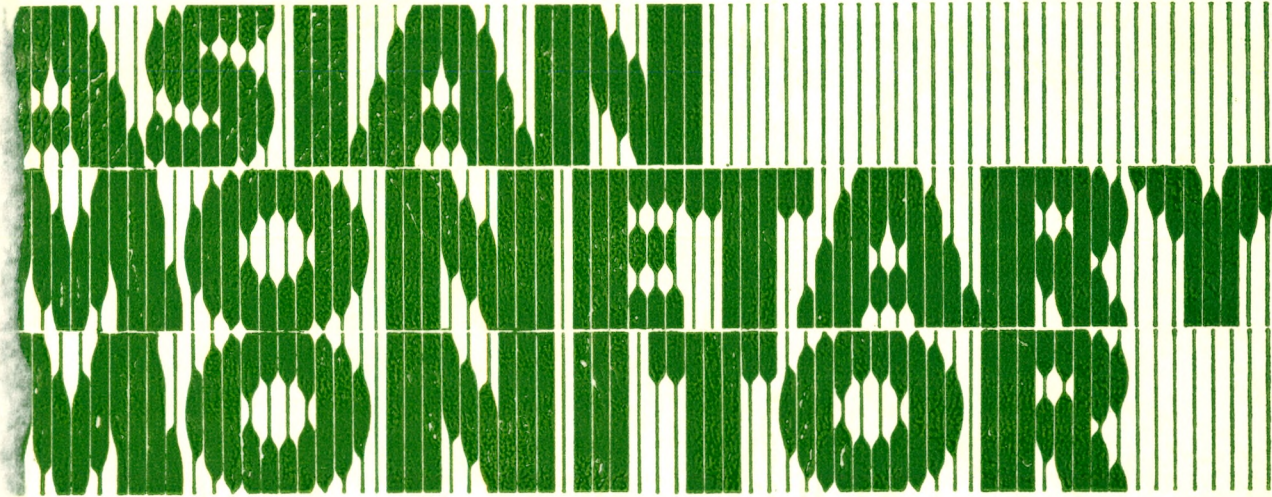




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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

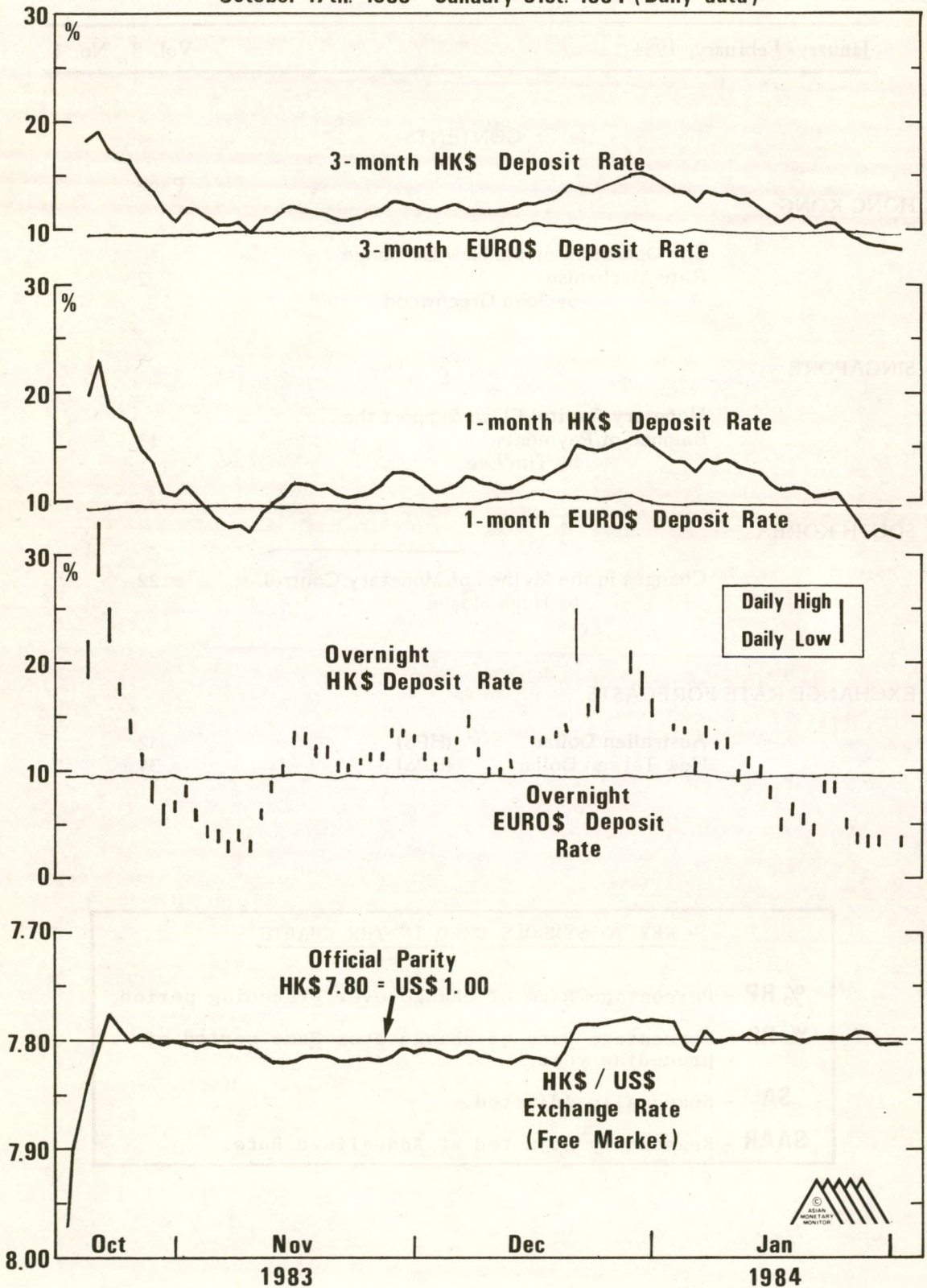
SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

HONG KONG : CHART 1

HK\$ / US\$ EXCHANGE RATE AND INTEREST RATE DIFFERENTIALS

October 17th. 1983 – January 31st. 1984 (Daily data)



THE OPERATION OF THE NEW EXCHANGE RATE MECHANISM

When the new system for issuing Hong Kong dollar banknotes was implemented from Monday, October 17th 1983 there was a widespread lack of understanding about how the scheme would operate to stabilise the exchange rate for the Hong Kong currency, and consequently a high degree of scepticism that the new official exchange rate of HK\$7.80 per US dollar could be maintained for very long. Also, because the HK\$7.80 rate was considerably above the market rates of 8.30-40 that had been prevalent on Friday, October 14th, the implementation of the new scheme seemed to provide a heaven-sent opportunity to sell Hong Kong dollars and obtain US dollars while the new parity lasted. Now that the scheme has been in operation for several months and the sceptics who sold Hong Kong dollars in October have been confounded, it is appropriate to explain why the system is so resilient, and to examine the operation of the scheme with respect to (a) the behaviour of interest rates in the Hong Kong dollar money market, (b) the behaviour of the money supply since the implementation of the new scheme, and (c) the likely behaviour of the monetary and other nominal variables under alternative assumptions about the real economy.

(a) The Behaviour of Interest Rates under the New Mechanism

The monetary arrangements set up in October 1983 established a fixed parity between the Certificates of Indebtedness issued to the note-issuing banks as cover for their banknote issue, and the US dollar. Effectively this means that units of Hong Kong's monetary base are simply different denominations of the US dollar, because the government guarantees their convertibility into US dollars at the fixed price. As long as the authorities have sufficient foreign currency reserves to cover the entire HK\$ note issue, convertibility is assured.

Given the equivalence of Hong Kong dollars and US dollars at the official parity - and this depends on the assumption that the parity will not be altered - lenders and borrowers of credit in these two currencies ought to be indifferent between the two. Lenders will therefore try to lend in the currency offering higher interest rates, and borrowers will try to borrow in the currency offering lower interest rates. Also, arbitrageurs will borrow in the country with lower rates and lend in the country with higher rates. By these processes money market interest rates for various maturities in each country will tend to equality in the long term. In the short term, two sets of factors can interfere with the equality of interest rates: short term balance of payments disequilibria and short-term variations in the supply and demand for credit. In the long term the mechanism is self-correcting so that interest rate differentials will be eliminated, but in the short term both can produce significant interest rate differentials, particularly for short term interest rates.

As a way of studying the recent experience of Hong Kong since the introduction of a fixed parity for Certificates of Indebtedness (i.e. HK\$ banknotes at one remove), it is useful to consider the case of (a) an overall balance of payments deficit due to capital outflows, and (b) a reduction in the supply of credit or loanable funds due to large scale conversions of deposits into currency by the non-bank public. (See Box on pp. 4-5.) These correspond to the two "tests" to which the classical gold standard was subject, namely the external drain and the internal drain.

HOW THE SELF-CORRECTING MECHANISM OPERATES UNDER THE NEW SCHEME

THE EXTERNAL DRAIN

- (1) An external drain occurs when there is a widespread conversion of Hong Kong dollars (deposits or currency) into foreign currency associated with an overall balance of payments deficit. To simplify we shall follow the process through the books of the banks for a single transaction representing total net outflows.
- (2) Suppose that Customer X with substantial HK\$ deposits at Bank A sells HK\$ for US\$, and that the HK\$ are purchased by Customer Y, who maintains his account at Bank B. Customer X's HK\$ account is debited and he receives a US\$ draft (or credit to a US\$ account) equivalent to the HK\$ amount sold at the free market rate of exchange, less any commissions or other charges. Initially the HK\$ funds are transferred from Customer X's account to the clearing account of Bank A, and a cheque drawn on that account is issued to Bank B.
- (3) To settle, Bank A's clearing account is debited and Bank B's clearing account is credited, and subsequently Customer Y's account at Bank B is credited in HK\$.
- (4) For the banking system as a whole there is at this point no change in the quantity of HK\$ deposits, but the increased demand for HK\$ or the downward shift in demand for HK\$ relative to US\$ evident in the sale of HK\$ for US\$, will have pushed the free market rate for HK\$ away from the 7.80 parity towards 7.81, 7.82 or 7.83. Depending on the relative demand for HK\$ and US\$ and therefore how far the HK\$ falls against the US\$, there will at some stage be an incentive for banks with HK\$ cash currency balances to sell US\$ for HK\$ at the free market rate (say 7.8350), and then take HK\$ banknotes to the note-issuing banks for redemption by the Exchange fund at the official rate of 7.80, pocketing the difference between the market rate and the official rate (i.e. HK\$0.035 or 3 1/2 cents per US\$).
- (5) The sale of HK\$ banknotes to the Exchange Fund reduces the amount of HK\$ cash currency in the system, and makes it likely that one or more other banks will be short of cash currency or short term liquid funds relative to their deposit liabilities. To alleviate this shortage and ensure they have funds readily available, these banks will initially borrow short-term HK\$ funds in the overnight market to top up their clearing accounts (or they must sell US\$ to the Exchange Fund to obtain HK\$ cash). The new borrowing in the HK\$ overnight market will drive up HK\$ interest rates, and through arbitrage in the local money market (borrowing longer term to lend at short term) and in the forward foreign exchange market (borrowing US\$ funds to lend in HK\$), the rise in overnight rates will be transmitted to the whole spectrum of interest rates in Hong Kong.
- (6) Higher interest rates in Hong Kong will reduce the amount of profitable lending opportunities for banks, this will slow down credit-creation, and as a result deposit growth will slow down. In this way the money supply declines or slows down in the aftermath of a net balance of payments deficit or external drain.

THE INTERNAL DRAIN

- (1) An internal drain occurs when there is a widespread conversion by bank customers of HK\$ deposits to HK\$ cash currency. This could occur for purely seasonal reasons (e.g. at Christmas or at Chinese New Year), or because of a run on a bank, or in the case of a generalised banking panic.
- (2) The withdrawal of deposits in the form of cash causes an equal depletion of both bank deposits and banks' cash balances. This will adversely affect banks' previous cash-to-deposit ratios; alternatively banks' loans and investments will have risen in relation to their deposits. Banks will now seek to restore their cash-to-deposit ratios, and they will be more reluctant to make new loans.
- (3) To restore their HK\$ cash positions, banks must sell US\$ to the Exchange Fund and obtain HK\$ banknotes. If they do not have free US\$ balances the banks will have to bid for them in the free market, and this will tend to raise the value of the HK\$ relative to the US\$.
- (4) Meanwhile the shortage of HK\$ cash in bank portfolios will induce in some banks the same response as in the case of the external drain: an upward shift in demand for overnight interbank funds to replace the reduction in loanable funds, and a consequent rise in interbank interest rates. By the same mechanisms as in the external drain, these higher rates will be transmitted to the whole spectrum of interest rates in Hong Kong.
- (5) As in the case of the external drain higher interest rates will lead to less credit-creation and slower monetary growth. In this way an internal drain produces a contractionary or deflationary effect on the monetary system.

The new Hong Kong monetary system which was launched on October 17th 1983 has already been "tested" by both types of drain, and in each case the disruption or disequilibrium has been overcome within a few days. This is a tribute both to the underlying strength of the new mechanism, and to the efficiency of Hong Kong's money and foreign exchange markets.

An example of the external drain occurred immediately after the new scheme was implemented. Since the free market exchange rate for the US dollar had been around HK\$8.30-40 in the few days preceding the setting of the new parity at HK\$7.80, and since there was almost universal scepticism that the government could fix the exchange rate at any level and hold it there in the face of huge capital outflows, the new rate of HK\$7.80 seemed like a splendid opportunity to cash in Hong Kong dollars and obtain US dollars at a particularly favourable rate (which surely would not last). Consequently there was considerable selling of Hong Kong dollars, so that although the leading banks had started out with quotations of HK\$7.7950-7.8050, the free market rate soon tumbled to around HK\$7.95. As explained in the Box (p. 4) this induced some banks to redeem HK\$ cash currency, while others, wary of their liquidity positions as their deposits were run down, had to borrow short term funds in the HK\$ money market, pushing short term interest rates up sharply (see Chart 1). At one stage overnight rates hit 42%. One month deposit rates went to 25% or thereabouts, while 3-month deposit rates rose to almost 20%. As shown in the chart, however, it took only 4 or 5 trading days for HK\$ interest rates in the overnight markets to return to the same level as overnight Eurodollar rates, and within 10 trading days Hong Kong dollar overnight rates were substantially below equivalent Eurodollar rates. Basically the attraction of interest rates in excess of 20% in a currency which was now fixed to and therefore equivalent to US dollars was too good an opportunity to miss, so those who understood the new mechanism borrowed Eurodollars to lend in Hong Kong, thus helping to bring the HK\$ exchange rate back towards parity and reducing the interest rate differential in the two currencies.

The next significant episode - at Christmas time - provided a clear example of the mechanism of the internal drain at work. Chart 1 shows how first of all overnight rates began to rise as deposits were converted to cash currency ahead of the 4-day Christmas holiday. The rise in HK\$ interest rates led to a strengthening of the Hong Kong dollar against the US dollar, and a decisive move from below parity to above parity. Basically what was happening was that the total money supply remained unchanged, but its composition changed so that cash currency increased by approximately HK\$920 million in the week ending December 24th. This implied an increase of about 7% in the cash currency held by the non-bank public, and a correspondingly smaller percentage decrease in the total volume of HK\$ deposits. Since the supply of loanable funds was reduced, interest rates had to rise to restore equilibrium in the credit markets. This time overnight interest rates peaked at just over 30% but term rates did not rise nearly so high. Immediately after Christmas and New Year the demand for HK\$ cash currency subsided, the supply of loanable funds was increased, and the upward pressure on interest rates in the money markets relaxed, so that the free market exchange rate for Hong Kong dollars returned from a premium to parity, to a level very close to the parity (see Chart 1). Once again longer term deposit interest rates gradually returned to the levels of US interest rates.

To summarise, the new Hong Kong monetary arrangements have now been put to the test of both an external drain and an internal drain. In a purely technical sense there is no other "test" to which the system can be subjected. In the event of a capital flight, Hong Kong will see a repeat of the October episode; in the event of a conversion of HK\$ deposits into HK\$ currency Hong Kong will see a repeat of the Christmas and New Year

episode. In practical terms, however, the severity of future episodes in each case could be significantly greater, particularly in the case of a run on one or more banks. While this would raise short-term interest rates further and hence increase the incentives for banks and other arbitrageurs to bring funds in and restore equilibrium, it could also expose the system to fears that claims on the Hong Kong banks were not safe. A prolonged episode of this kind would severely test the adaptive capacity of the Hong Kong economy to deflationary conditions. It is essential if the automatic mechanism is to work well in the future

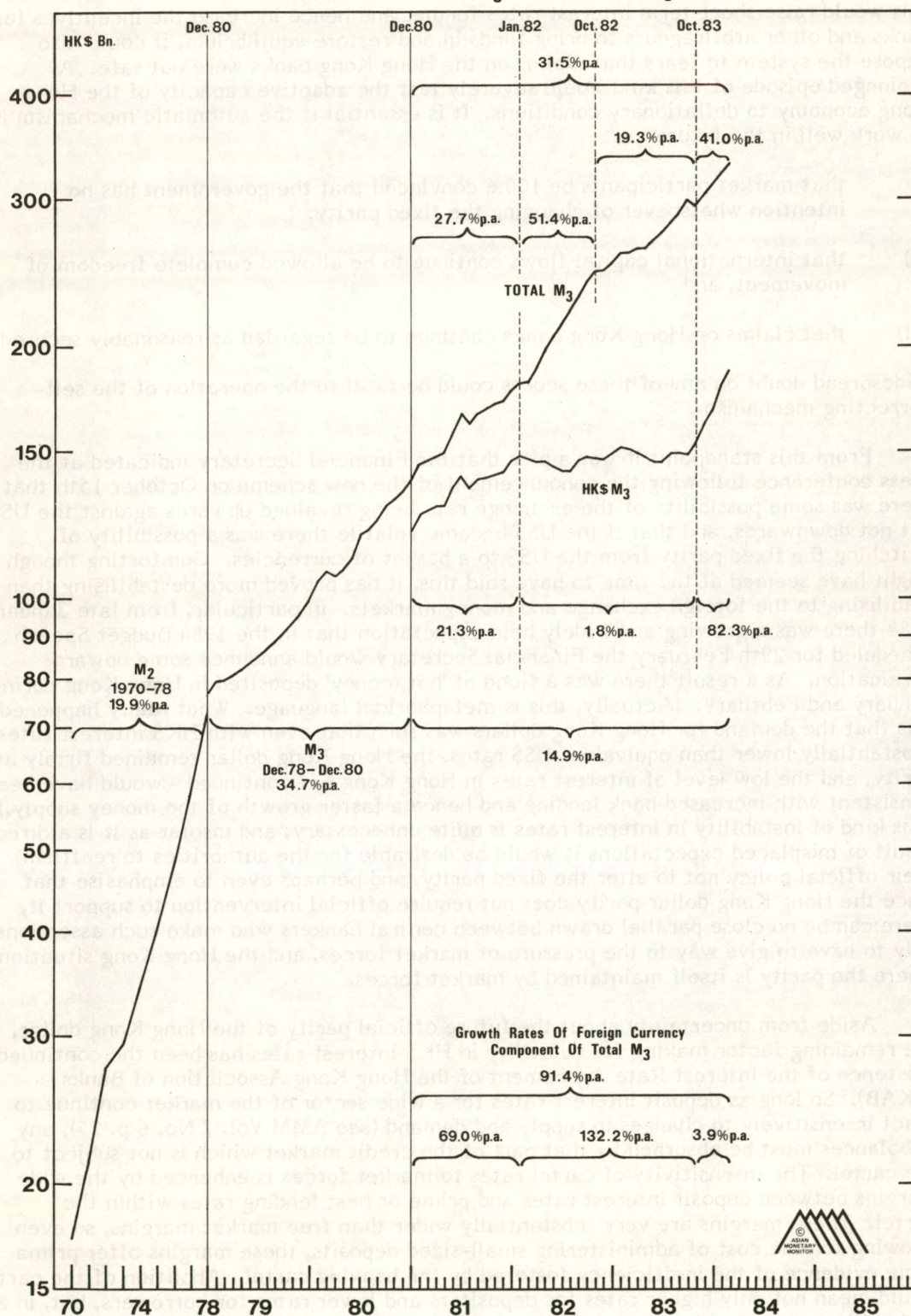
- (i) that market participants be 100% convinced that the government has no intention whatsoever of changing the fixed parity,
- (ii) that international capital flows continue to be allowed complete freedom of movement, and
- (iii) that claims on Hong Kong banks continue to be regarded as reasonably secure .

Widespread doubt on any of these scores could be fatal to the operation of the self-correcting mechanism.

From this standpoint it was a pity that the Financial Secretary indicated at the press conference following the announcement of the new scheme on October 15th that there was some possibility of the exchange rate being revalued upwards against the US\$, but not downwards, and that if the US\$ became volatile there was a possibility of switching the fixed parity from the US\$ to a basket of currencies. Comforting though it might have seemed at the time to have said this, it has proved more destabilising than stabilising to the foreign exchange and money markets. In particular, from late January 1984 there was a growing and widely held expectation that in the 1984 Budget Speech scheduled for 29th February the Financial Secretary would announce some upward revaluation. As a result there was a flood of 'hot money' deposited in Hong Kong during January and February. (Actually, this is metaphorical language. What really happened was that the demand for Hong Kong dollars was such that even with HK\$ interest rates substantially lower than equivalent US\$ rates, the Hong Kong dollar remained firmly at parity, and the low level of interest rates in Hong Kong - if continued - would have been consistent with increased bank lending and hence a faster growth of the money supply.) This kind of instability in interest rates is quite unnecessary, and insofar as it is a direct result of misplaced expectations it would be desirable for the authorities to reaffirm their official policy not to alter the fixed parity, and perhaps even to emphasise that since the Hong Kong dollar parity does not require official intervention to support it, there can be no close parallel drawn between central bankers who make such assertions only to have to give way to the pressure of market forces, and the Hong Kong situation where the parity is itself maintained by market forces.

Aside from uncertainty about the future official parity of the Hong Kong dollar, the remaining factor making for volatility in HK\$ interest rates has been the continued existence of the Interest Rate Agreement of the Hong Kong Association of Banks (HKAB). So long as deposit interest rates for a wide sector of the market continue to react insensitively to changes in supply and demand (see AMM Vol. 7 No. 6 p. 25), any imbalances must be absorbed by that part of the credit market which is not subject to the cartel. The insensitivity of cartel rates to market forces is enhanced by the wide margins between deposit interest rates and prime or best lending rates within the cartel. These margins are very substantially wider than free market margins, so even allowing for the cost of administering small-sized deposits, these margins offer prima facie evidence of the inefficiency fostered by the banking cartel. Abolition of the cartel would mean not only higher rates for depositors and lower rates for borrowers, but, in all probability, more stable interest rates throughout the Hong Kong financial system under any given set of circumstances.

HONG KONG : CHART 2 GROWTH OF HK\$ M₃ AND TOTAL M₃



Note: The growth rate of foreign currency deposits is expressed in HK\$ terms, and is therefore significantly affected by the depreciation of the HK\$ over the whole period since December 1980 when separate data first became available. For example, expressed in US\$ terms the growth rate of the foreign currency component of Total M₃ since Dec. 1980 is 67.8% p.a.

(b) Monetary Growth under the New Mechanism

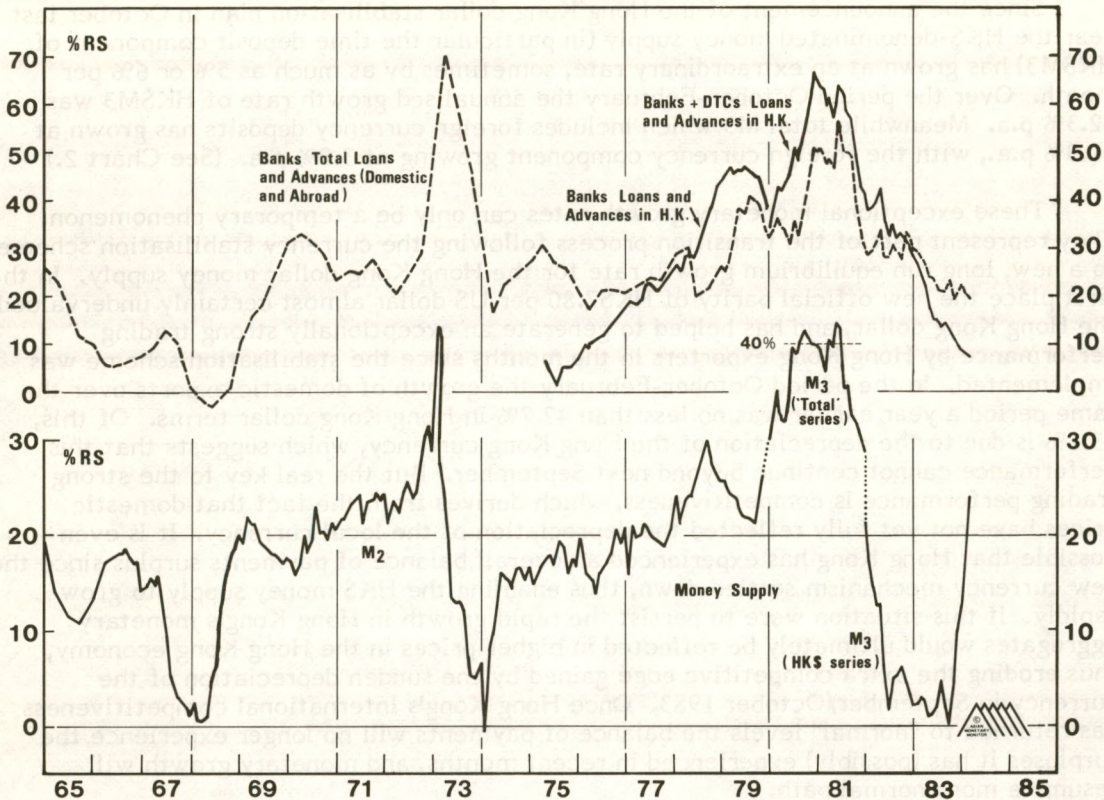
Since the announcement of the Hong Kong dollar stabilisation plan in October last year the HK\$-denominated money supply (in particular the time deposit component of HK\$M3) has grown at an extraordinary rate, sometimes by as much as 5% or 6% per month. Over the period October-February the annualised growth rate of HK\$M3 was 82.3% p.a. Meanwhile total M3 which includes foreign currency deposits has grown at 41.0% p.a., with the foreign currency component growing at 3.9% p.a. (See Chart 2.)

These exceptional monetary growth rates can only be a temporary phenomenon. They represent part of the transition process following the currency stabilisation scheme to a new, long run equilibrium growth rate for the Hong Kong dollar money supply. In the first place the new official parity of HK\$7.80 per US dollar almost certainly undervalued the Hong Kong dollar, and has helped to generate an exceptionally strong trading performance by Hong Kong exporters in the months since the stabilisation scheme was implemented. In the period October-February the growth of domestic exports over the same period a year earlier was no less than 42.7% in Hong Kong dollar terms. Of this, 23.1% is due to the depreciation of the Hong Kong currency, which suggests that this performance cannot continue beyond next September. But the real key to the strong trading performance is competitiveness, which derives from the fact that domestic prices have not yet fully reflected the depreciation of the local currency. It is even possible that Hong Kong has experienced an overall balance of payments surplus since the new currency mechanism settled down, thus enabling the HK\$ money supply to grow rapidly. If this situation were to persist the rapid growth in Hong Kong's monetary aggregates would ultimately be reflected in higher prices in the Hong Kong economy, thus eroding the extra competitive edge gained by the sudden depreciation of the currency in September/October 1983. Once Hong Kong's international competitiveness has returned to "normal" levels the balance of payments will no longer experience the surpluses it has (possibly) experienced in recent months, and monetary growth will resume a more normal path.

Second, the resumption of rapid HK\$-denominated monetary growth reflects in part, we suspect, a statistical quirk produced by the past growth of swap deposits. During the period from February 1982 to October 1983 foreign currency deposits at banks in Hong Kong were exempt from a 10% withholding tax on interest to which Hong Kong dollar deposits were liable. In addition, because small-sized Hong Kong dollar deposits were subject to the Interest Rate Agreement of the HKAB, it was profitable for depositors to "swap" HK\$ deposits into US\$ deposits and thus avoid both the interest withholding tax and the interest rate ceilings of the HKAB cartel. From a statistical point of view it seems that these deposits were reported as foreign currency deposits, even though the depositor still ended up holding HK\$, and this is part of the explanation for the slow growth rate of HK\$M3 in the period from early 1982 until October 1983. With the abolition of the residual 10% withholding tax on HK\$ deposit interest payments, and the stabilisation of the HK\$/US\$ exchange rate there is now little incentive to switch to US\$ deposits, and accordingly many Hong Kong holders of such swap deposits have been reported as unwinding their positions. One supporting strand of evidence suggesting that the rapid growth of HK\$M3 is likely to be a temporary phenomenon is that loan demand in Hong Kong remains extremely weak (see Chart 3) so that the apparent monetary growth has not been associated with new credit creation.

This upsurge in HK\$M3, however, is probably better viewed as part of the general revival of a willingness to hold Hong Kong dollar assets following the currency stabilisation scheme. While the exchange rate was still floating, and particularly in August and September 1983 there was wholesale dumping of all types of Hong Kong

HONG KONG
CHART 3: MONEY AND CREDIT GROWTH



dollar assets - property, businesses, equities and currency. Once the currency was stabilised, that whole process gradually went into reverse, and the build-up of HK\$-denominated money supply can be viewed, from the demand side, as a resumption of the public's willingness to hold real money balances in Hong Kong dollars again. From this perspective the question to answer is, how far should we expect holders of HK\$ money balances to wish to restore their holdings of HK\$ deposits and currency? If we could estimate their required transactions balances for any given past level of income, it might be possible to make some kind of estimate, based on current income levels, of the amount of money balances we should expect Hong Kong people to hold now that the disincentives to holding HK\$ balances have been removed. Once Hong Kong dollar balances in deposits and currency had returned to these levels we could say that the transition period following the implementation of the new exchange rate mechanism was nearly over. (It would still be necessary for price levels to adjust to the new level of money balances, and only after that adjustment was accomplished could one say that the transition was completed.)

For the long term Hong Kong's monetary growth rate will adjust to whatever is consistent with an overall balance of payments equilibrium, which in turn will depend upon such factors as the growth rate of the economy, the desired holdings of HK\$ money balances, and the overall level of prices in Hong Kong. We now turn to a brief consideration of these factors under alternative assumptions about the performance of the Hong Kong economy.

(c) Behaviour of Monetary and Other Variables under Alternative Assumptions about the Real Economy

In two economies whose currencies are linked together by a fixed parity which is expected to remain fixed at a constant rate, interest rates and price levels must tend to equality in the long term in some aggregate sense. This is simply an application of the law known as the law of one price which predicts that in any one currency area the prices of identical goods and services will tend to equality, allowing only for differences in transportation costs. If this holds in a single currency area, it will also be true for two currency areas whose currencies are permanently fixed at a rigid parity, because this will mean that one currency is essentially a different denomination of the other. This was very clear under the gold exchange standard where all major currencies were defined in terms of a fixed weight and fineness of gold, but it is equally applicable to fiat currencies such as the US\$ and the HK\$ today.

However, although this is true for prices (and interest rates are merely a price- the price of credit), it is not necessarily true for the quantity of money. For two very similar countries with a roughly equal income level and growth rate, and a similar level of financial sophistication, it could be true that identical monetary growth rates would maintain balance of payments equilibrium in the long run, but for two economies as different as Hong Kong and the United States this is most unlikely to be true. In fact the rate of growth of the quantity of money in each economy must accommodate the possibility of different real growth rates (i.e. differing requirements for transactions balances), differing desires for the accumulation of money balances relative to income (i.e. different income elasticities of demand for money balances), and yet still produce equilibrium in the balance of payments if the fixed parity is to remain intact.

For ease of exposition we shall consider two alternative scenarios which assume a constant growth rate in the United States with (1) a slow-growing or stagnant Hong Kong economy or with (2) a rapidly growing and prosperous Hong Kong economy.

The first scenario assumes a generally pessimistic outlook for Hong Kong after 1997. Real capital expenditures might be halved, but remain sufficient to maintain and expand the existing capital stock, and consequently the economic growth rate could gradually decline to a rate of (say) 3.5% p.a., equal to the long term real growth rate of the U.S.A. In order to maintain the price level in Hong Kong at a level which is consistent with equilibrium in the balance of payments it will be necessary for the money supply to grow at roughly the same rate as the money supply in the United States, adjusted for the differential demand for money balances in each country. In the early phases of such a transformation of the Hong Kong economy there might be considerable capital outflows as investment opportunities abroad appeared more favourable than the returns available in Hong Kong. If, temporarily, these capital outflows were to produce an overall balance of payments deficit and a short-term downturn in Hong Kong's money supply, in time the overall price level (including wages) in Hong Kong would adjust to a level somewhat lower than overall prices in the U.S.A. This would give Hong Kong exporters a competitive advantage, enabling Hong Kong to generate a balance of trade or current account surplus sufficient to finance the deficit on capital account. (An important question for Hong Kong is how long would this adjustment process take, and what would be the interim consequences prior to the current account surplus being generated?)

The second scenario assumes a generally optimistic outlook for Hong Kong after 1997. We could assume that capital expenditures would resume their past buoyancy, and that consequently the economic growth rate would continue at something close to the double digit rates it has achieved in the recent past. In order to maintain the price level in Hong Kong at a level consistent with balance of payments equilibrium under these circumstances it will be necessary for the quantity of money to grow much more rapidly than the money supply in the United States, because not only would transactions requirements in Hong Kong be growing much more rapidly, but also one could predict from past experience that the growth in demand for money balances was such that an additional 3-4% p.a. would be required. Thus, under this kind of scenario and assuming a 9% real growth rate in Hong Kong and a 5% inflation rate in the United States, Hong Kong would require an average money growth rate of around 18% p.a. (9% plus 5% plus 4%) to maintain rough equality of prices with the U.S.A.

Under both scenarios the money supply adjusts automatically and without government intervention as a consequence of a combination of factors: the balance of payments position, the demand for transactions balances and other incremental demand for money balances, and the relative inflation rates in Hong Kong and the United States. The new monetary system in Hong Kong thus provides a well-trying mechanism which is capable of accommodating both buoyant or stagnant economic conditions. Because it operates through maintaining balance of payments equilibrium, and because Hong Kong is such an open economy, the mechanism will ensure that the monetary system adjusts rapidly to the needs of the economy. The strength of the mechanism is that it is automatic and impartial to the problems of particular sectors, and it therefore avoids the value judgments as between certain types of industry or employee which other discretionary mechanisms would almost certainly imply. In the uncertain years that lie ahead it is our view that Hong Kong people should have the maximum opportunity to arrange their assets and property as they see best. In this sense the new monetary system is fully compatible with the preservation of the prosperity and stability of the people of Hong Kong.

MONETARY CAPITAL FLOWS SUPPORT THE BALANCE OF PAYMENTS

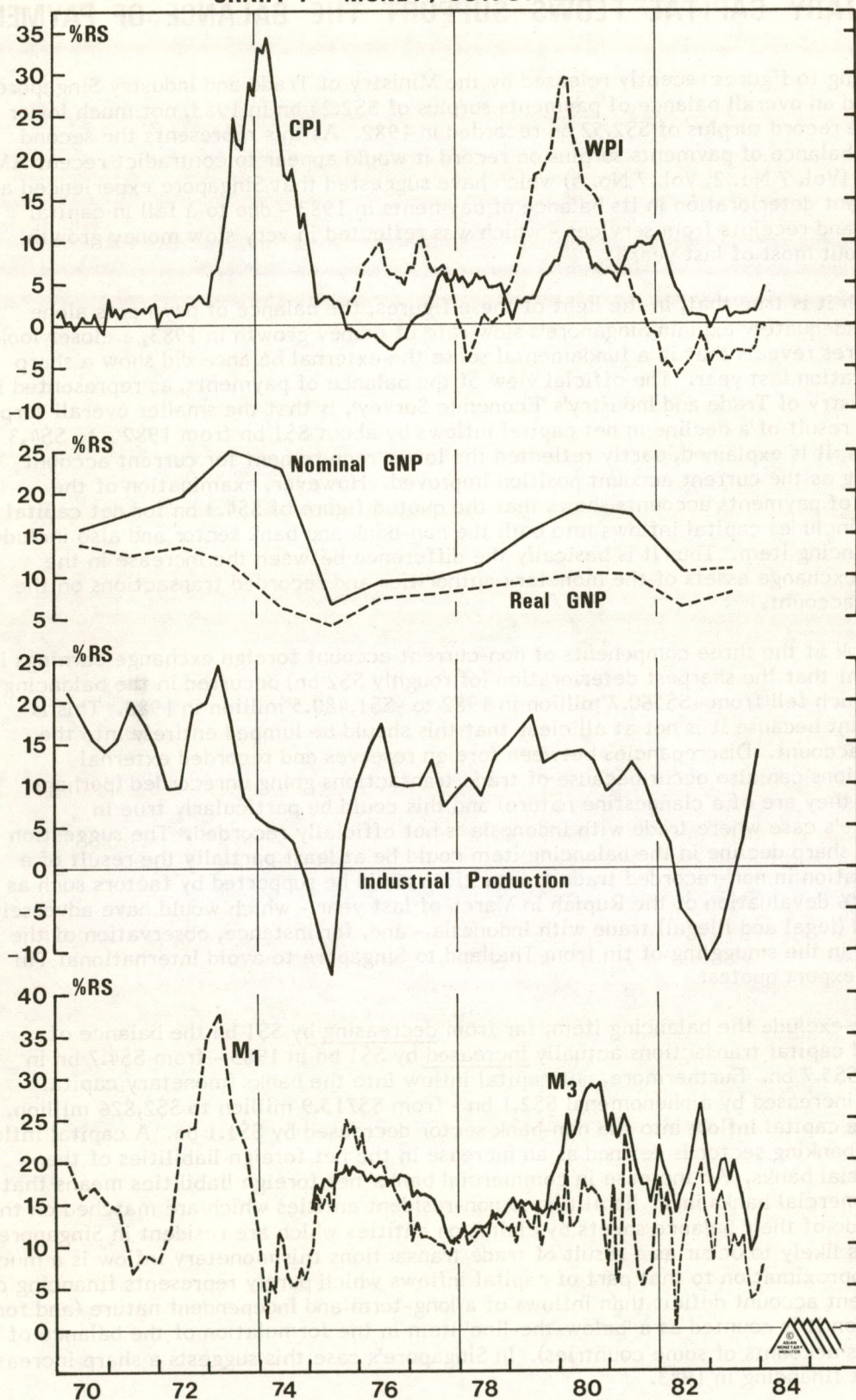
According to figures recently released by the Ministry of Trade and Industry Singapore recorded an overall balance of payments surplus of S\$2.24 bn in 1983, not much lower than the record surplus of S\$2.52 bn recorded in 1982. As this represents the second highest balance of payments surplus on record it would appear to contradict recent AMM articles (Vol. 7 No. 2, Vol. 7 No. 5) which have suggested that Singapore experienced a significant deterioration in its balance of payments in 1983 - due to a fall in capital inflows and receipts from services - which was reflected in very slow money growth throughout most of last year.

Although it is true that, in the light of these figures, the balance of payments alone cannot adequately explain Singapore's slow rate of money growth in 1983, a closer look at the figures reveals that in a fundamental sense the external balance did show a sharp deterioration last year. The official view of the balance of payments, as represented in the Ministry of Trade and Industry's 'Economic Survey', is that the smaller overall surplus was the result of a decline in net capital inflows by about S\$1 bn from 1982 - to S\$4.3 bn. This, it is explained, partly reflected the lower requirement for current account financing as the current account position improved. However, examination of the balance of payments accounts shows that the quoted figure of S\$4.3 bn for net capital inflows includes capital inflows into both the non-bank and bank sector and also includes the balancing item. Thus it is basically the difference between the increase in the foreign exchange assets of the monetary authorities and recorded transactions on the current account.

If we look at the three components of non-current account foreign exchange earnings it is evident that the sharpest deterioration (of roughly S\$2 bn) occurred in the balancing item, which fell from +S\$560.7 million in 1982 to -S\$1,480.5 million in 1983. This is significant because it is not at all clear that this should be lumped entirely into the capital account. Discrepancies between foreign reserves and recorded external transactions can also occur because of trade transactions going unrecorded (perhaps because they are of a clandestine nature) and this could be particularly true in Singapore's case where trade with Indonesia is not officially recorded. The suggestion that the sharp decline in the balancing item could be at least partially the result of a deterioration in non-recorded trade transactions could be supported by factors such as the 27.6% devaluation of the Rupiah in March of last year - which would have adversely affected (legal and illegal) trade with Indonesia - and, for instance, observation of the increase in the smuggling of tin from Thailand to Singapore to avoid International Tin Council export quotas.

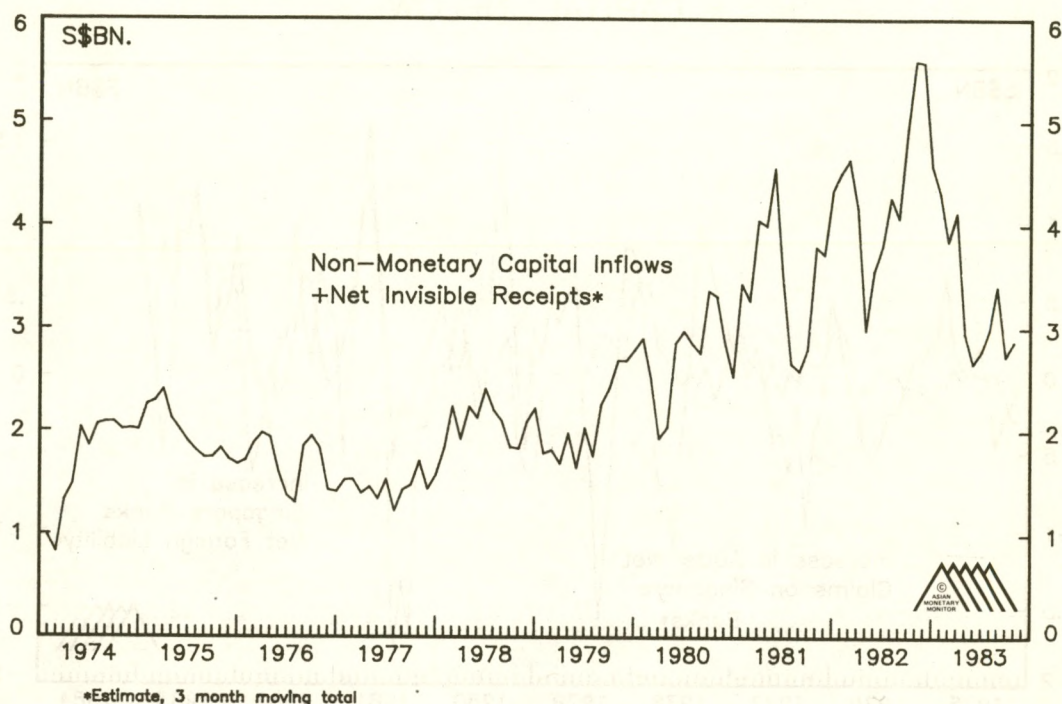
When we exclude the balancing item, far from decreasing by S\$1 bn the balance of recorded capital transactions actually increased by S\$1 bn in 1983 - from S\$4.7 bn in 1982 to S\$5.7 bn. Furthermore, net capital inflow into the banks (monetary capital inflows) increased by a phenomenal S\$2.1 bn - from S\$715.9 million to S\$2,826 million, while the capital inflow into the non-bank sector decreased by S\$1.1 bn. A capital inflow into the banking sector is defined as an increase in the net foreign liabilities of the commercial banks. An increase in commercial banks' net foreign liabilities means that the commercial banks incur liabilities to non-resident entities which are matched on the assets side of their balance sheets by claims on entities which are resident in Singapore. As this is likely to occur as a result of trade transactions this monetary inflow is a much closer approximation to that part of capital inflows which purely represents financing of the current account deficit than inflows of a long-term and independent nature (and for this reason it is counted as a 'below-the-line' item in the formulation of the balance of payments accounts of some countries). In Singapore's case this suggests a sharp increase in deficit financing in 1983.

SINGAPORE
CHART 1 : MONEY, OUTPUT AND PRICES



SINGAPORE

CHART 2: NON-TRADE "BASIC BALANCE"



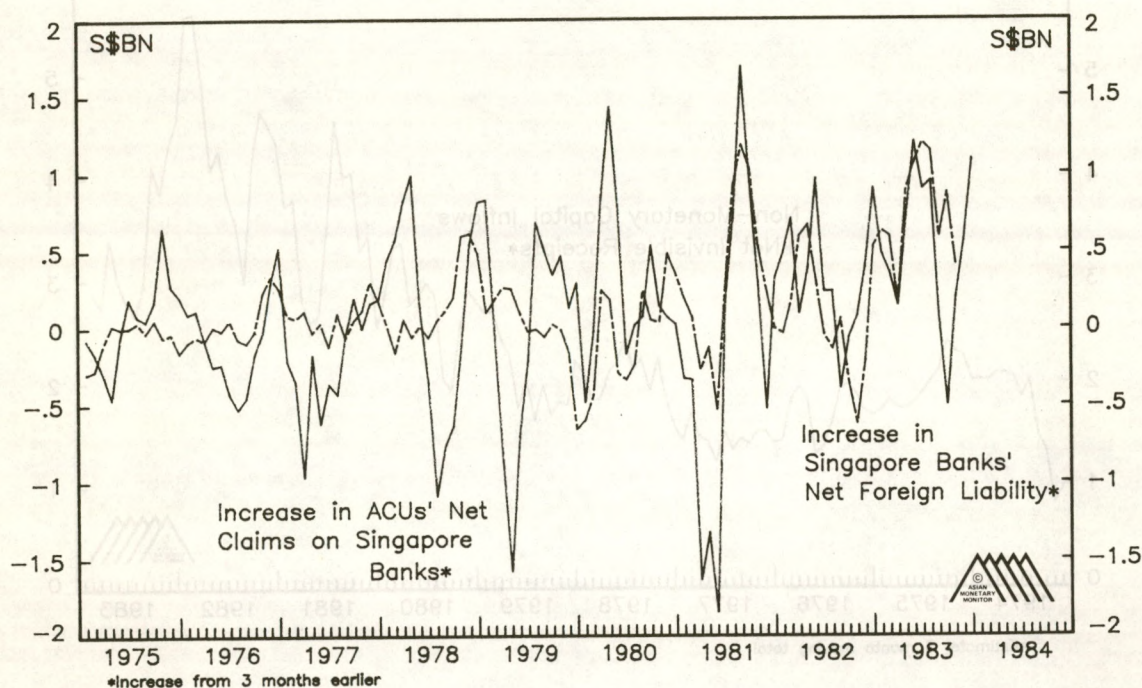
A better idea of the true behaviour of Singapore's balance of payments in 1983 can be gleaned by removing monetary capital inflows from the overall balance altogether, and arriving at a concept more akin to the basic balance (current account balance plus long-term capital inflows). By this measure Singapore experienced its first deficit in 1983 - of S\$588 million - since 1965, after a surplus of S\$1.8 bn in 1982.

The reason for this marked deterioration in Singapore's 'basic balance' in 1983 was clearly a sharp decline in net earnings from services (invisibles) and the deterioration in non-monetary capital inflows referred to above. The balance of services declined from S\$12.05 bn in 1982 to S\$10.62 bn in 1983, by far the largest decline ever in this category of foreign exchange earnings. The cause of weakness in invisible earnings can be traced to a decline in earnings from shipping services and no growth in net earnings from tourism. The balance on non-monetary capital inflows - which includes items such as direct investment and portfolio investment - declined from S\$4.02 bn in 1982 to S\$2.91 bn in 1983.

Although Singapore does not publish balance of payments statistics on a monthly basis, a good approximation for the monthly behaviour of the aggregate of net receipts from services and non-monetary capital inflows can be obtained by subtracting the trade balance from the increase in official foreign reserves and the banking sector's net external assets, all of which are available monthly. This series, which should differ from the sum of the balance on services and non-monetary capital inflows only in so far as valuation differences affect official foreign reserves, is illustrated on Chart 2 in the form of a three month moving total. The extent of the decline in 'non-trade foreign exchange earnings' between October 1982 and October 1983 can be seen clearly from the chart.

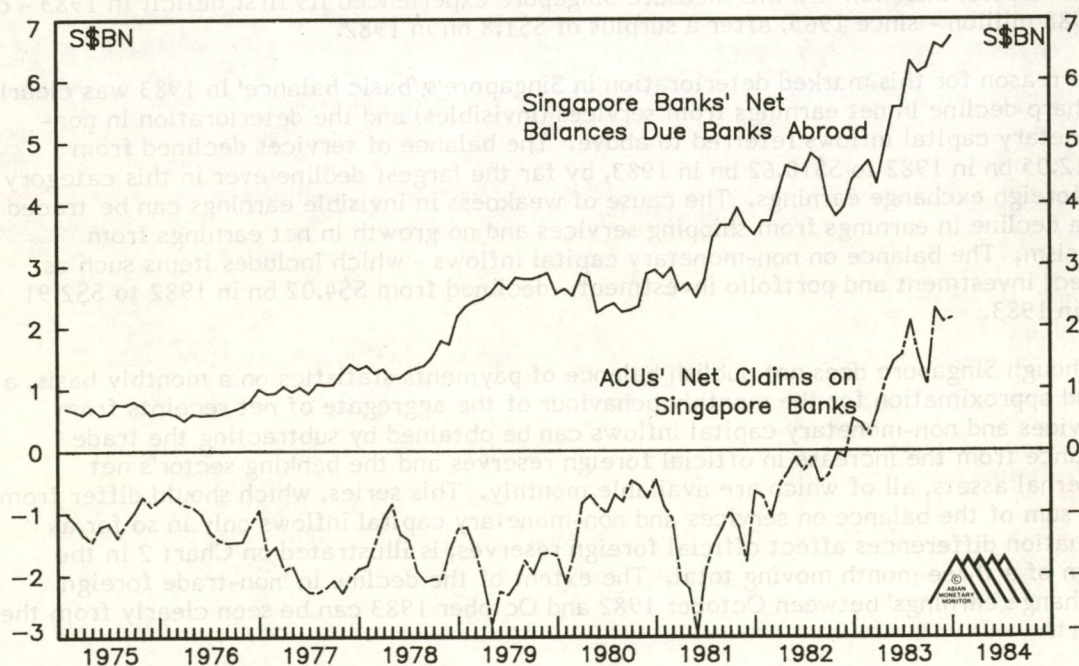
SINGAPORE

CHART 3: ACUs AND THE MONETARY CAPITAL INFLOW



SINGAPORE

CHART 4: ACU CLAIMS ON SINGAPORE BANKS



For the year 1983 as a whole Singapore did register an improvement in its trade account, the deficit on which narrowed from S\$14.59 bn in 1982 to S\$12.42 bn. However, this improvement can be traced entirely to the last five months of the year. The conclusion is that between October 1982 and July 1983 the balance of payments was supported almost entirely by capital inflows into the banks.

In the nine months between October 1982 and July 1983, the net amount due from commercial banks in Singapore to banks outside Singapore rose from S\$3.80 bn to S\$6.31 bn, representing a capital inflow of S\$2.51 bn over this period. By the end of 1983 the banking sector's net liability to non-resident banks had risen further, to S\$6.70 bn, by far its largest net foreign liability position on record.

If one assumes that Singapore's commercial banks are not going to hold such a large liability to non-resident banks forever then, in a certain sense, this phenomenal rise in commercial banks' net liability to non-resident banks represents the extent to which the deterioration in the basic balance of payments last year was not 'properly financed' in a long-term sense. For 'proper financing' of a basic balance deficit to occur, in a managed exchange rate regime, the authorities must run down official reserves, inducing a monetary squeeze which acts to correct the deficit by attracting long-term capital flows and slowing import growth, as well as increasing export competitiveness. If the deficit is financed by the commercial banks this only postpones financing until such a time as the claims against the banks corresponding to their liabilities are realised by the holders, or alternatively, until the net liability is eliminated by a pick-up in exports of goods and services, or non-monetary capital inflows.

In fact, examination of the banking statistics reveals that the increase in net inter-bank claims on Singapore banks which corresponds to the increase in the Singaporean banks' net external liabilities is almost totally in the hands of Singapore based Asian Currency Units. Interbank funds held by Asian Currency Units in Singapore banks exceeded inter-bank borrowings from Singapore banks by S\$2.30 bn by October 1983. In November 1982 borrowings exceeded funds held by S\$111 million, making the net capital flow from ACUs to Singapore banks in the eleven month period S\$2.41 bn. (Charts 3 and 4 demonstrate the extent of the monetary capital inflow since 1981, and the large inflow during 1983, and how this is largely comprised of interbank lending to Singapore Banks by Asian Currency Units.)

Asian Currency Units are separate accounting units of banks and other financial institutions in Singapore which were set up to transact in the Asian dollar market. Thus their main business is accepting U.S. dollar deposits from non-residents and lending them to non-residents in the Asian region. As such they are no different from any other offshore banks in that their assets and liabilities are largely US dollars and they operate externally to Singapore's monetary system. However, since the complete liberalisation of exchange controls in June 1978, ACUs have had greater access to the domestic market in that they are able to accept deposits in foreign currencies from Singapore residents without any limits or restrictions, and make loans in all foreign currencies to Singapore residents without prior exchange control approval. This has obvious balance of payments implications in that an ACU could lend US dollars to a corporation resident in Singapore to finance an import made by that corporation.

The current large build-up in ACUs' net claims on domestic Singapore banks is significant because prior to December 1982 ACUs always had a net interbank liability to Singapore banks i.e. they were net borrowers in the Singapore inter-bank market (see Chart 4). Thus, their current position as net depositors of an amount equivalent to S\$2.14 bn takes on a somewhat ominous tone.

There are a number of conceivable reasons why ACUs may lend funds in the Singapore inter-bank market - it may constitute a convenient use of funds when Asian dollar lending opportunities are weak, or it may represent a switch of funds in the Asian dollar market from US dollars to Singapore dollars in anticipation of weakness in the US unit (this occurred in 1977/78 when, between October 1977 and April 1978, as the US dollar fell sharply ACUs were net lenders to Singapore banks of an amount equivalent to S\$1.43 bn) or ACU lending to a domestic Singapore bank may represent funding for a loan by the domestic bank to an importer. Although it is only in this third case that the ACU lending would represent direct current account deficit financing, in practice the distinction matters little. In all cases a build-up of Singapore domestic banks' net liabilities to ACUs implies a build-up in liabilities to offshore entities which are not natural holders of Singapore assets, backed by claims on resident entities. Also, corresponding to this build-up there must be an increase in the net outstanding US dollar borrowings or short US dollar positions of residents (probably initially importers) and/or the net outstanding Singapore dollar lending or long Singapore dollar positions of non-residents (probably initially exporters). This latter point implies that the monetary capital inflow is less likely to turn into an outflow while the US dollar remains on a weakening trend.

To summarise, the sum of Singapore's net foreign exchange earnings from trade, services and non-monetary capital inflows declined sharply in 1983. The balance of payments surplus was supported at a high level by a huge increase in monetary capital inflows, in particular net inter-bank lending to domestic Singapore banks by Asian Currency Units.

However, as suggested earlier a decline in Singapore's basic balance of payments cannot explain tight liquidity in 1983 while the monetary capital inflow was so large. The important balance of payments determinant for the monetary base, and hence money supply, is the change in the monetary authorities' net foreign assets and all other things being equal an increase in monetary capital inflows will lead to an increase in the monetary authorities' net foreign assets just as an increase in any other form of foreign exchange earning will. For an explanation of the very slow growth of both M1 and M2 throughout most of 1983 (evident on Charts 1 and 7) we must look at the government component of monetary base growth.

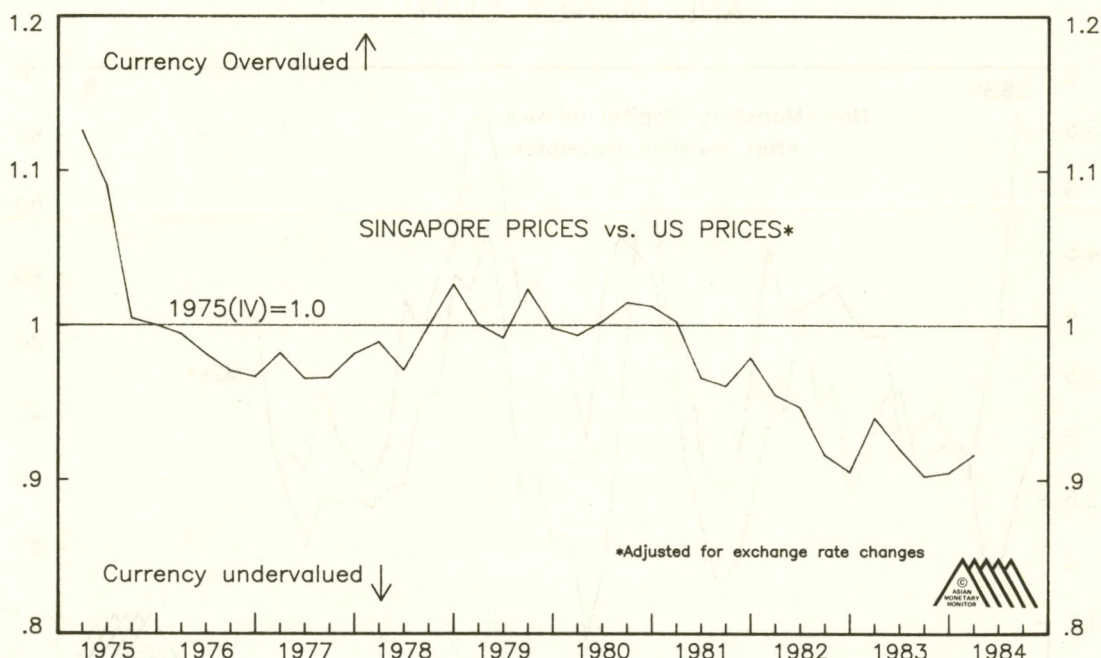
Unfortunately, although we know that the government's operations have a substantial net contractionary influence on the monetary base, it is difficult to establish in exact degree because the government's budget does not fully reflect all the relevant public sector expenditures and revenues, and the MAS does not publish a detailed balance sheet of its own.

If we consider the budget position alone then the government's fiscal stance appears to have been becoming more expansionary over recent years. (The 1983 budget was in a deficit of S\$2.76 bn, and the recent budget projected a deficit of S\$3.92 bn for 1984.) However, the budget position of the central government is not at all an accurate reflection of the central government's monetary influence as it effectively includes certain expenditures undertaken by the major statutory boards (especially the Housing and Development Board) but does not fully reflect the revenues of those boards. If we take the widest measure of the authorities' fiscal stance - the public sector deficit - then this shows a very different magnitude and tendency. The public sector deficit, which includes all expenditures and revenues of the seven major statutory boards, showed a shortfall of a mere S\$49 million in 1983, down from a deficit of S\$553 million in 1982.

However the authorities' major influence on the money supply comes through the operation of the forced savings scheme - the Central Provident Fund. With an increase

SINGAPORE

CHART 5: PRICE COMPETITIVENESS



in contribution rates from July of 1983 and a rise in the salary ceiling from November, the net inflow into the fund rose to S\$3.8 bn in 1983, from S\$3.5 bn in 1982. Thus, as a very rough and ready guide, a simple addition of the public sector deficit and CPF net inflow suggests that the authorities' net contractionary influence on the monetary base was in the order of S\$800 m greater in 1983 than in 1982.

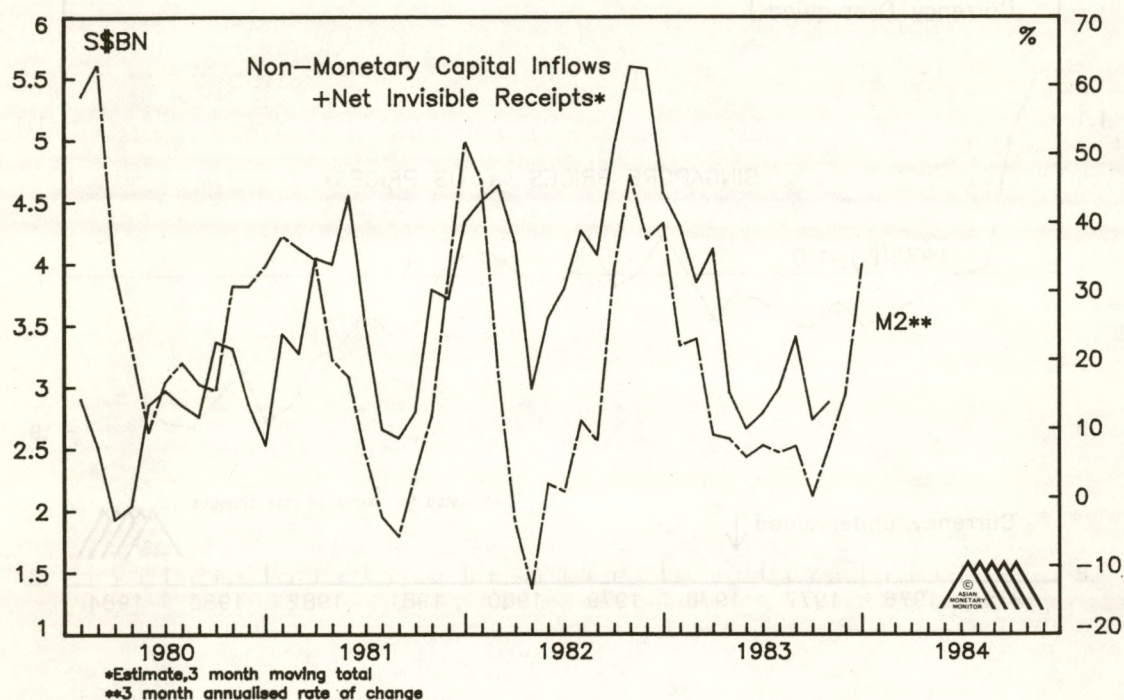
An analysis of IMF statistics for the balance sheet of the combined monetary authorities (MAS and the Board of Commissioners of the Currency) indicates that the monetary base was growing at a year-on-year rate of 11.4% in August 1983, down from a peak rate of 21.2% in November 1982. A breakdown of the contributions to the August year-on-year rate of growth (which is again only a rough guide as certain items which for monetary analysis purposes should be included in 'government deposits' are instead included in 'other items') suggests a 'government' component of -104.0%, and a 'foreign assets' component of +46.2% with 'other items' contributing the residual +69.2%.

Hence it can be concluded that, at least in terms of a numerical analysis, the low rate of money growth last year was largely a reflection of an increased contractionary influence of the government. However, in theory a central bank or monetary authority has it in its power to determine its own balance sheet at any time. As it knows the size of treasury balances, it can, if it chooses to do so, easily act to offset the government's effect on the monetary base by (in this case) buying assets from the private sector. In the case of the MAS these assets would be foreign currency as the bulk of the MAS' monetary operations are in the form of direct currency intervention or currency swaps.

In practice the constraint on the MAS acting in this way is its implicit exchange rate target. The MAS aims to keep an exchange rate which is basically stable in the short-run, but over the last eight years it has tended to gradually appreciate the Singapore

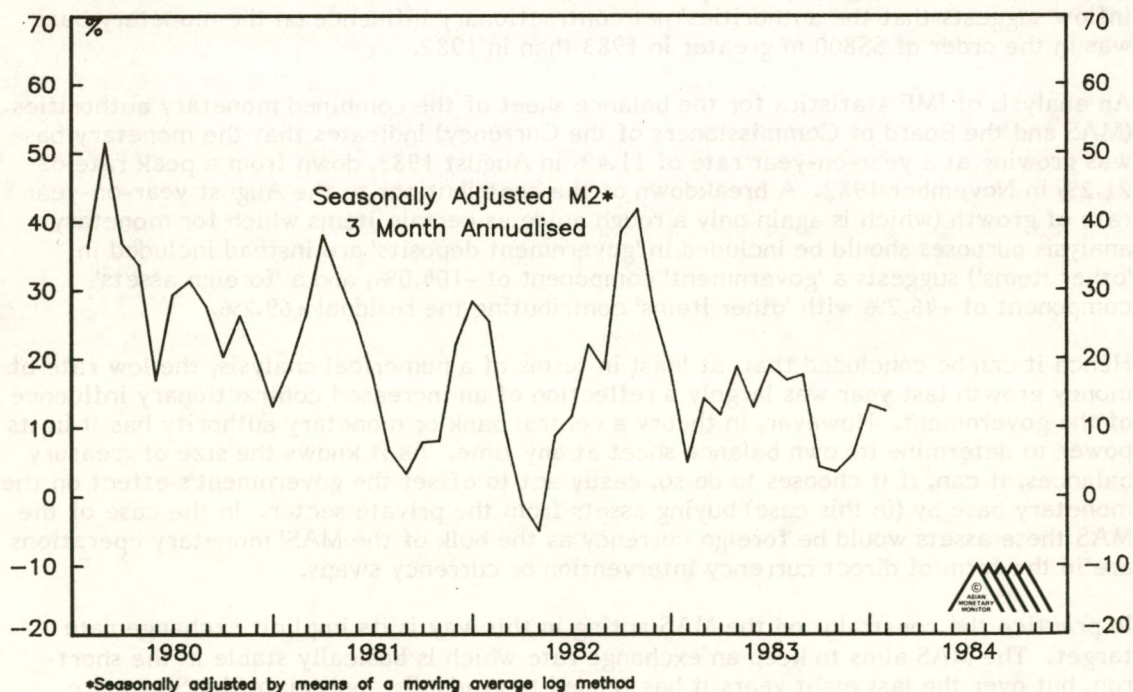
SINGAPORE

CHART 6: NON-TRADE "BASIC BALANCE" AND MONEY SUPPLY



SINGAPORE

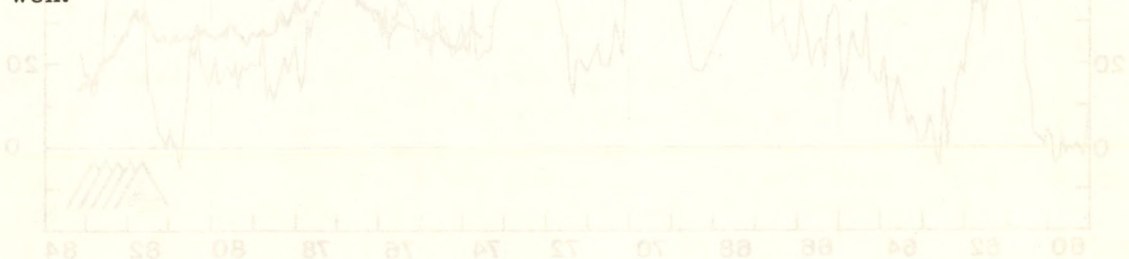
CHART 7: SEASONALLY ADJUSTED MONEY



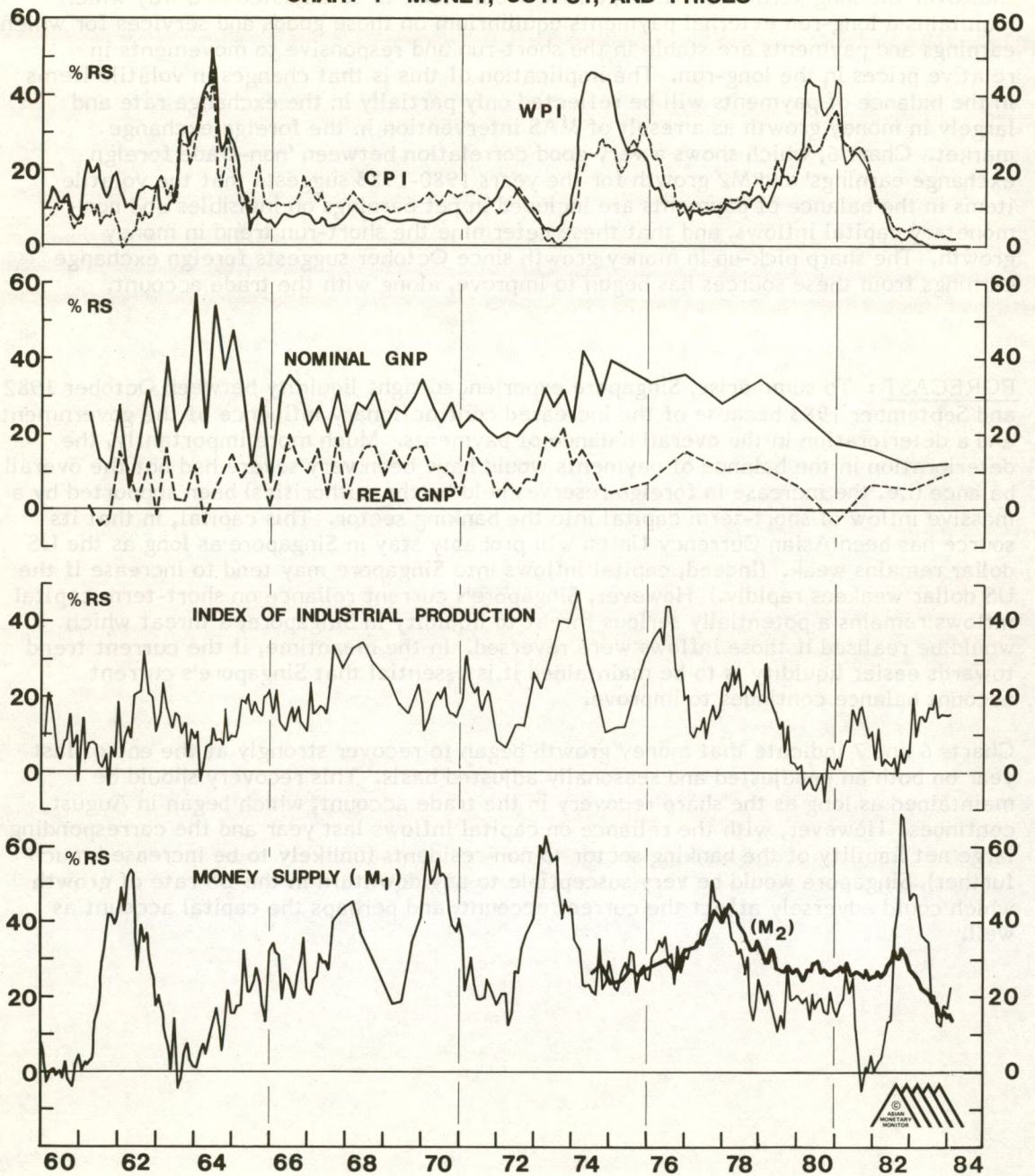
dollar very much in line with purchasing power parity (Chart 5). This would tend to imply that over the long-term the exchange rate should tend to be adjusted in a way which maintains a long-run external payments equilibrium on those goods and services for which earnings and payments are stable in the short-run and responsive to movements in relative prices in the long-run. The implication of this is that changes in volatile items in the balance of payments will be reflected only partially in the exchange rate and largely in money growth as a result of MAS intervention in the foreign exchange market. Chart 6, which shows a very good correlation between 'non-trade foreign exchange earnings' and M2 growth for the years 1980-1983 suggests that the volatile items in the balance of payments are included in net earnings on invisibles and non-monetary capital inflows, and that these determine the short-run trend in money growth. The sharp pick-up in money growth since October suggests foreign exchange earnings from these sources has begun to improve, along with the trade account.

FORECAST : To summarise, Singapore experienced tight liquidity between October 1982 and September 1983 because of the increased contractionary influence of the government and a deterioration in the overall balance of payments. Much more importantly, the deterioration in the balance of payments would have been very severe had not the overall balance (i.e. the increase in foreign reserves held by the authorities) been supported by a massive inflow of short-term capital into the banking sector. This capital, in that its source has been Asian Currency Units, will probably stay in Singapore as long as the US dollar remains weak. (Indeed, capital inflows into Singapore may tend to increase if the US dollar weakens rapidly.) However, Singapore's current reliance on short-term capital inflows remains a potentially serious threat to liquidity in Singapore, a threat which would be realised if those inflows were reversed. In the meantime, if the current trend towards easier liquidity is to be maintained it is essential that Singapore's current account balance continues to improve.

Charts 6 and 7 indicate that money growth began to recover strongly at the end of last year on both an unadjusted and seasonally adjusted basis. This recovery should be maintained as long as the sharp recovery in the trade account, which began in August, continues. However, with the reliance on capital inflows last year and the corresponding large net liability of the banking sector to non-residents (unlikely to be increased much further), Singapore would be very susceptible to any downturn in the US rate of growth which could adversely affect the current account, and perhaps the capital account as well.



SOUTH KOREA **CHART 1 : MONEY, OUTPUT, AND PRICES**



SOUTH KOREA

CHANGES IN THE METHOD OF MONETARY CONTROL

The conduct of monetary policy in Korea has been dramatically reformed over the last four years. During this period the Bank of Korea has moved to establish direct control over domestic monetary growth.

This change in the Bank of Korea's approach to monetary control culminated in a severe contraction in monetary growth last year, where M2 growth was halved from the rates prevailing in late 1982. Although the size of the monetary contraction was not exceptional by the standards of previous business cycles (see Chart 1) the economic forces underlying the downturn were unique. In assuming direct control over local monetary growth the Bank of Korea also assumed direct responsibility for the level of domestic inflation. Thus when Korea's revised Five Year Plan for Economic Development (1982-86) accorded "particular emphasis" to attaining price stability, the Bank of Korea was effectively charged with reducing monetary growth to levels consistent with this medium term policy objective. The consequent contraction in M2 growth from 26.9% in December 1982 to 16.4% in November 1983 was unique to Korea's monetary experience in that, effectively for the first time, it reflected a domestic policy preference.

Prior to January 1980 - when the Won was formally devalued by 16.6% to Won 580 - Korea had followed a pegged exchange rate policy. In theory, this policy implied that the principal constraint to domestic monetary growth was the trend in Korea's balance of payments. In practice, the Korean authorities did not adhere strictly to the Bretton Woods system of exchange rate management, for they were far more deeply committed to securing high rates of growth in the domestic economy. Thus the Korean authorities were willing to continue with a pegged exchange rate system whenever the exchange rate chosen was associated with an overall balance of payments surplus, a rise in the Bank of Korea's net foreign exchange holdings and strong growth in the monetary base and the wider monetary aggregates. However whenever, as in 1970, 1971, 1974 and 1979, a deterioration in the external account threatened to bring about much slower monetary growth in the domestic economy, the Bank of Korea stood ready to offset (see Chart 2) the decline in its net foreign exchange position by increasing the domestic component of the monetary base (i.e. increasing its purchases of government debt and raising lending to the commercial banks). This action maintained domestic monetary growth at a level higher than would otherwise have been the case, which in turn undermined the existing parity with the US dollar. Thus each of the Bank of Korea's major attempts to maintain a high level of monetary growth in the face of a deteriorating balance of payments position were accompanied by, or closely followed by a formal devaluation of the won.

The Operation of Korea's New Monetary System

The Bank of Korea abandoned this "lip service" to the pegged exchange rate system in January 1980. At that time the Bank of Korea commenced a routine of more or less continuous adjustments to the external value of the Korean Won. The Won is not yet allowed to float entirely freely on the foreign exchanges, but neither are adjustments in the Won exchange rate made for the purposes of domestic monetary control; the Bank of Korea does not deliberately depreciate or appreciate the Won for the purpose of expanding or contracting the monetary base. Instead, the Bank of Korea's active instruments of monetary control are now concentrated entirely in the domestic banking system.

The basic operation of monetary policy in Korea is now similar to that employed by the Bank of Japan since July 1974. Rather than targeting the price of money - either in the form of a pegged exchange rate or in the form of a heavily managed exchange rate - the Bank of Korea controls the quantity of money in the domestic economy. It does this by explicitly and directly controlling the growth of the reserve base of the local monetary system. The reserve base is defined as the quantity of currency in circulation plus banks' required reserves and differs (insignificantly, in Korea's case) from the monetary base only to the extent that it excludes excess reserves*. However unlike in Japan, where the Bank of Japan's main technique for controlling the growth of the monetary base is to vary its purchases of longer dated government debt, the Bank of Korea manages the growth of the reserve base by adjusting its claims on Korean Deposit Money Banks (i.e. Commercial Banks).

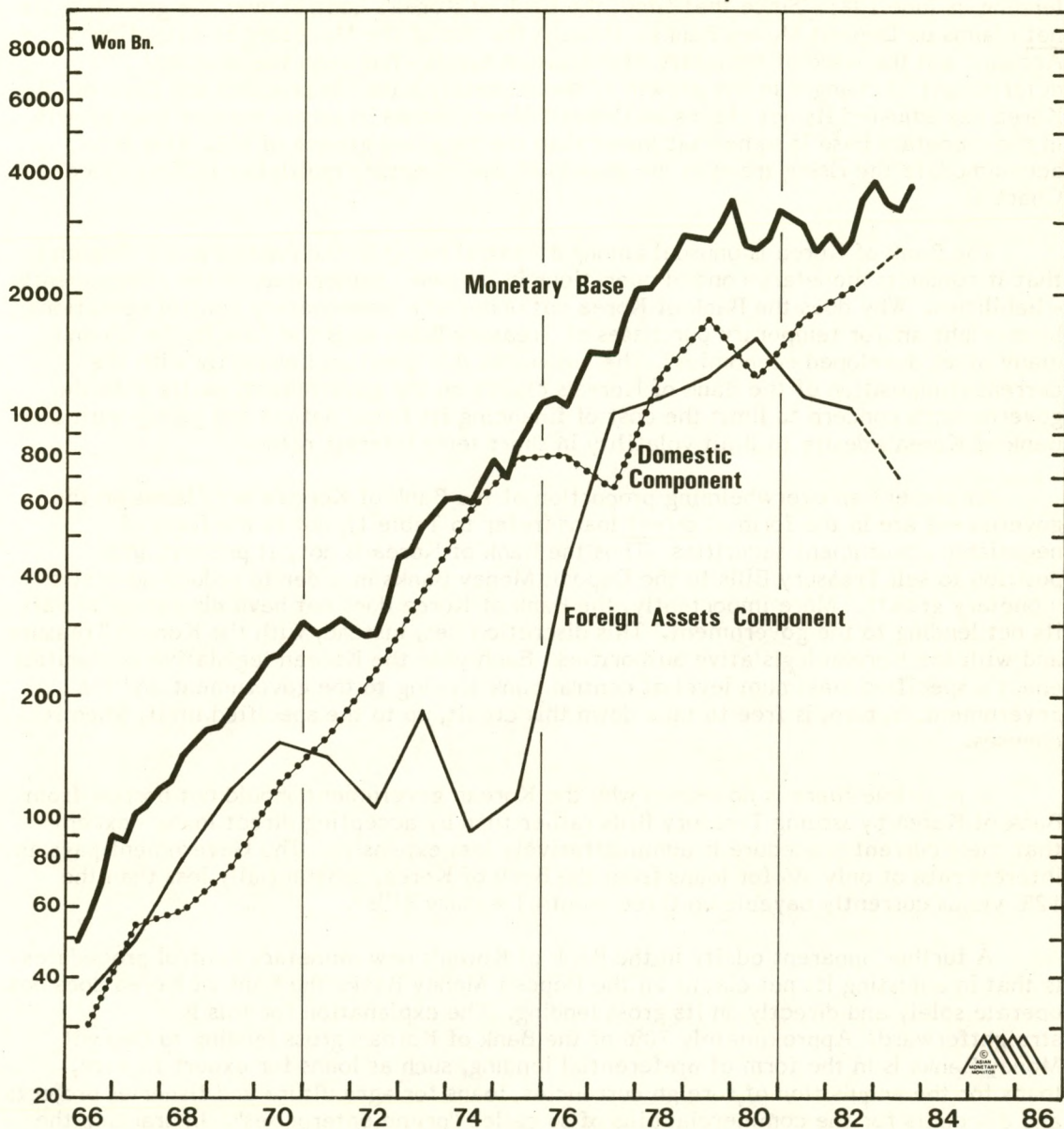
Chart 3 summarises the Bank of Korea's principal instruments of monetary control. Chart 3 records the growth of the monetary base, the central bank's gross claims on Deposit Money Banks and its claims on Deposit Money Banks net of both deposits held in the Monetary Stabilisation Account at the Bank of Korea and of Monetary Stabilisation Bonds issued by the Bank of Korea. Commercial Banks can be called to make deposits with the Monetary Stabilisation Account at any time by the Bank of Korea and the interest rates payable on such deposits, and repayment conditions are set by the Monetary Board at the Bank of Korea. Commercial Bank deposits in the Monetary Stabilisation Account are not regarded as reservable assets in the Korean banking system. Monetary Stabilisation Bonds are negotiable securities issued in the open market representing obligations of the Bank of Korea. The yield on these securities is equal to that payable on one year savings deposits at commercial banks. Monetary Stabilisation Bonds are issued specifically for the purpose of monetary control and are not regarded as reservable assets.

The use of the Monetary Stabilisation Account and the issue of Monetary Stabilisation Bonds are not altogether new features of the Korean banking system**.

* The Bank of Korea's definition of the Reserve Base is appropriate for the task of monetary control. Reservable assets in Korea consist only of deposits of Deposit Money Banks at the Bank of Korea (excluding deposits at the Monetary Stabilisation Account) and currency held by the Deposit Money Banks; they do not include any liabilities of the government. In addition, banks' deposits at the Bank of Korea earn below market rates of interest, so there is no incentive for banks to hold large quantities of excess reserves over and above those thought necessary for prudential purposes. The definition of the Reserve Base in Korea is therefore precisely the same as the definition of the Central Bank Money Stock - the Bundesbank's key monetary target variable - in W. Germany.

** For example, during the period between May 1st 1977 and the end of that year the Bank of Korea called for deposits to the Monetary Stabilisation Account (see Chart 3) in an attempt to subdue domestic money growth. During this interval, when M2 growth exceeded 40%, a system of marginal reserve requirements was introduced. 70% of commercial banks' incremental demand deposits and 40% of incremental time deposits were transferred to the Monetary Stabilisation Account at the Bank of Korea.

S. Korea : Chart 2
The Sources Of The Monetary Base



Nevertheless, as is evident in Chart 3, the Bank of Korea has expanded considerably its use of these instruments since the abolition of quantitative ceilings on commercial bank lending in June 1981. Since that time, the Bank of Korea's control over the growth in its net claims on Deposit Money Banks - through the use of the Monetary Stabilisation Account and the issue of Monetary Stabilisation Bonds - has been the principal determinant of changes in the growth of the monetary base. In practice the Bank of Korea has adjusted its net claims on Deposit Money Banks in such a manner that growth in the monetary base is somewhat lower than the targeted growth of M2. This is to accommodate the rising trend in the growth of the monetary multiplier in Korea (see Chart 4).

The Bank of Korea is unusual amongst central banks in the Asian Pacific Region in that it conducts monetary control operations in its own - rather than in the government's - liabilities. Why does the Bank of Korea not undertake its monetary control operations by outright and/or temporary purchases of Treasury Bills, as is the case in the US and many other developed economies? The answer to this question lies partly with the current composition of the Bank of Korea's claims on the government, partly with the government's concern to limit the cost of financing its fiscal deficit and partly with the Bank of Korea's desire to limit volatility in short term interest rates.

At present an overwhelming proportion of the Bank of Korea's net claims on the government are in the form of direct loans (refer to Table 1), not in the form of negotiable government securities. Thus the Bank of Korea is not, at present, in a position to sell Treasury Bills to the Deposit Money Banks in order to reduce domestic monetary growth. More importantly, the Bank of Korea does not have discretion to vary its net lending to the government. This discretion lies, instead, with the Korean Treasury and with the Korean legislative authorities. Each year the Korean legislative authorities enact a specified maximum level of central bank lending to the government and the government, in turn, is free to take down this credit, up to the specified limit, when it chooses.

In principle there is no reason why the Korean government should not borrow from Bank of Korea by issuing Treasury Bills rather than by accepting direct loans - except that their current procedure is administratively less expensive. The Government pays an interest rate of only 5% for loans from the Bank of Korea, substantially less than the 12% yields currently payable on three month Treasury Bills*.

A further apparent oddity in the Bank of Korea's new monetary control procedures is that in adjusting its net claims on the Deposit Money Banks the Bank of Korea does not operate solely and directly on its gross lending. The explanation for this is straightforward. Approximately 70% of the Bank of Korea's gross lending to Deposit Money Banks is in the form of preferential lending, such as loans for export finance, loans for the acquisition of foreign currencies, loans for agriculture and fisheries projects and discounts for the commercial bills of so called "prime enterprises". In practice the Bank of Korea is willing to supply freely credit facilities for certain, worthy categories

* Thus part of the burden of financing Korea's fiscal deficit has been transferred to the Bank of Korea. The Bank of Korea receives below market rates of interest from its loans to the government but must pay (close to) market interest rates on its issues of Monetary Stabilisation Bonds. This has contributed to the Bank of Korea suffering losses of Won 131.8 billion in 1982 and Won 108.8 billion in 1983 after enjoying substantial surpluses in prior years.

S. Korea : Chart 3
The Monetary Base And The Bank Of Korea's
Net Claims On Deposit Money Banks

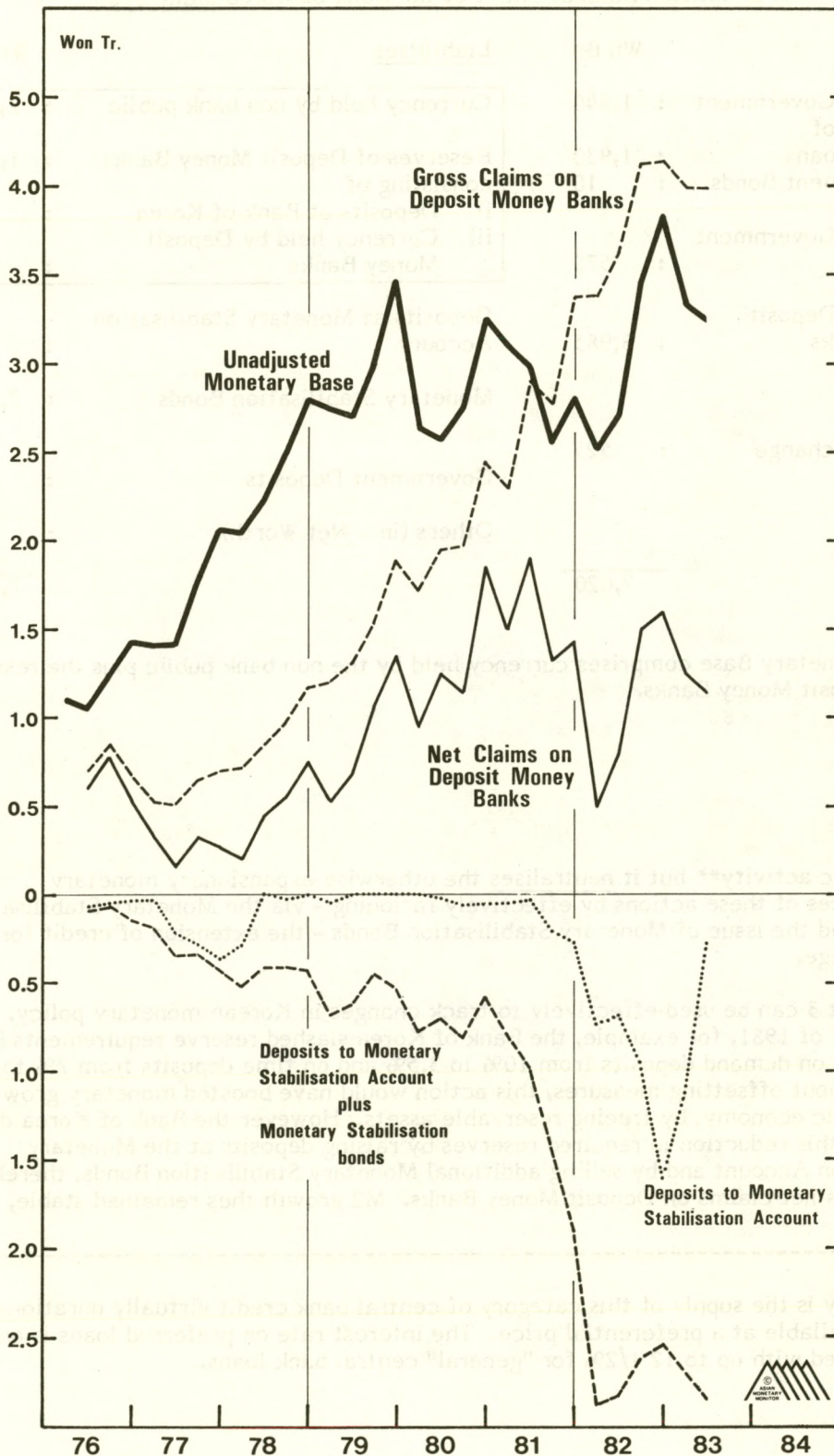


TABLE 1

A Simplified Balance Sheet of the Bank of Korea (June 1983)

Assets	Wn Bn	Liabilities	Wn Bn *
Claims on Government consisting of	: 1,940	Currency held by non bank public	: 2,140
i) Direct Loans	: 1,930	Reserves of Deposit Money Banks consisting of	: 1,010
ii) Government Bonds	: 10	i) Deposits at Bank of Korea	: 785
Claims on Government Agencies	: 570	ii) Currency held by Deposit Money Banks	: 225
Claims on Deposit Money Banks	: 3,985	Deposits at Monetary Stabilisation Account	: 270
Foreign Exchange (net)	: 525	Monetary Stabilisation Bonds	: 2,570
		Government Deposits	: 605
		Others (inc. Net Worth)	: 425
	<u>7,020</u>		<u>7,020</u>

* The Monetary Base comprises currency held by the non bank public plus the reserves of Deposit Money Banks.

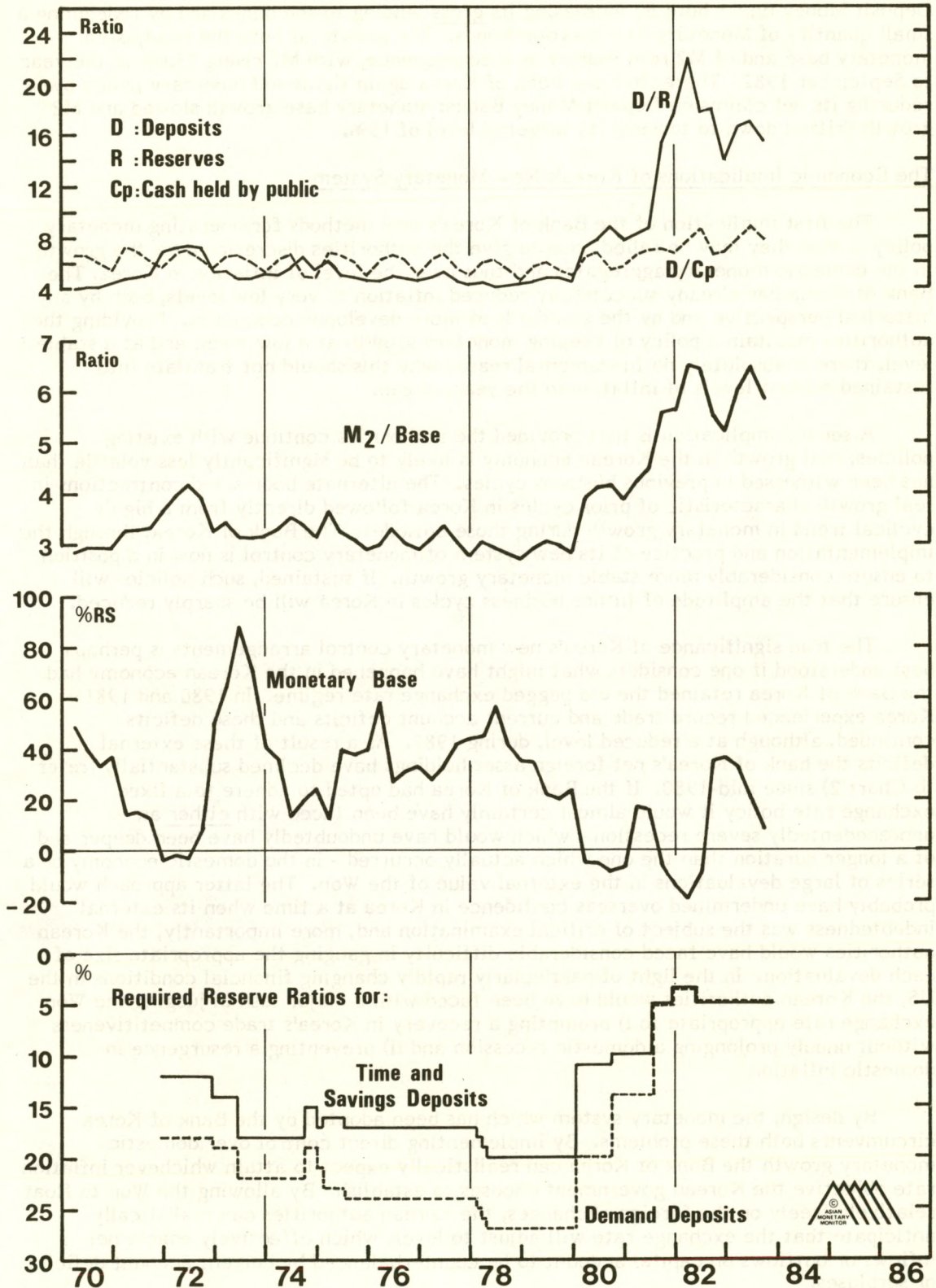
of economic activity** but it neutralises the otherwise expansionary monetary consequences of these actions by effectively rationing - via the Monetary Stabilisation Account and the issue of Monetary Stabilisation Bonds - the extension of credit for more general usage.

Chart 3 can be used effectively to track changes in Korean monetary policy. In the second half of 1981, for example, the Bank of Korea slashed reserve requirements (refer to Chart 4) on demand deposits from 10% to 3.5% and on time deposits from 7% to 3.5%. Without offsetting measures, this action would have boosted monetary growth in the domestic economy, by freeing reservable assets. However the Bank of Korea did neutralise this reduction in required reserves by raising deposits at the Monetary Stabilisation Account and by selling additional Monetary Stabilisation Bonds, thereby reducing its net claims on Deposit Money Banks. M2 growth thus remained stable, at

** Not only is the supply of this category of central bank credit virtually unrationed, but it is available at a preferential price. The interest rate on preferred loans is only 5%, compared with up to 12 1/2% for "general" central bank loans.

S. Korea: Chart 4

Monetary Determinant Ratios And The Growth Of The Monetary Base



around 25%, throughout 1981. However following the first Curb Market Scandal during the second quarter of 1982, the Bank of Korea eased monetary policy aggressively. This is displayed quite clearly in Chart 3. The Bank of Korea increased its net lending to the Deposit Money Banks both by increasing its gross lending to the banks and by redeeming a small quantity of Monetary Stabilisation Bonds. The growth of both the unadjusted monetary base and of M2 rose sharply as a consequence, with M2 rising 33.6% in the year to September 1982. Thereafter the Bank of Korea again tightened monetary policy by reducing its net claims on Deposit Money Banks: monetary base growth slowed and M2 growth drifted down to towards its targeted level of 15%.

The Economic Implications of Korea's New Monetary System

The first implication of the Bank of Korea's new methods for operating monetary policy is that they may be relied upon to give the authorities discretion over the growth in the domestic monetary aggregates and thus over the level of inflation in Korea. The Bank of Korea has already successfully reduced inflation to very low levels, both by any historical perspective and by the standards of more developed economies. Providing the authorities maintain a policy of keeping monetary growth at a low level, and at a stable level, there is absolutely no fundamental reason why this should not translate into sustained modest levels of inflation in the years ahead.

A second implication is that provided the authorities continue with existing policies, real growth in the Korean economy is likely to be significantly less volatile than has been witnessed in previous business cycles. The alternate booms and contractions in real growth characteristic of prior cycles in Korea followed directly from a highly cyclical trend in monetary growth during those episodes. The Bank of Korea, through the implementation and practice of its new system of monetary control is now in a position to ensure considerably more stable monetary growth. If sustained, such policies will ensure that the amplitude of future business cycles in Korea will be sharply reduced.

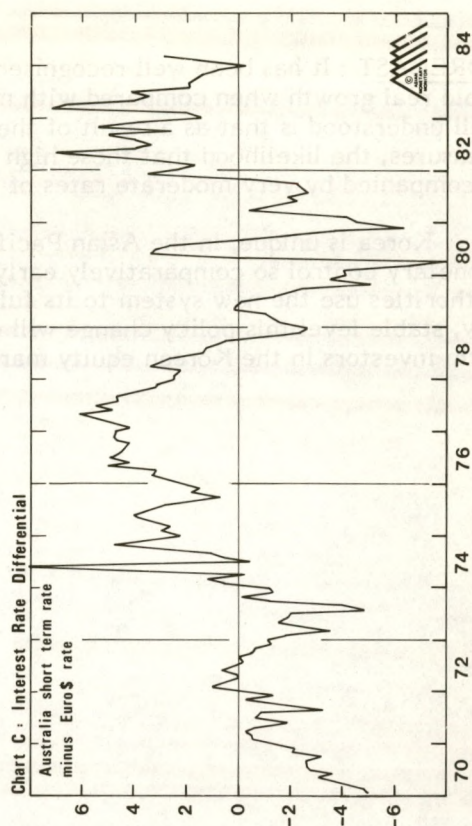
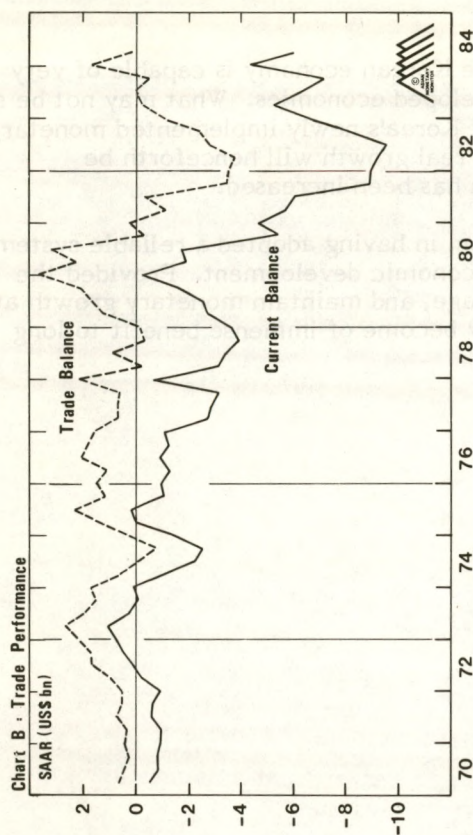
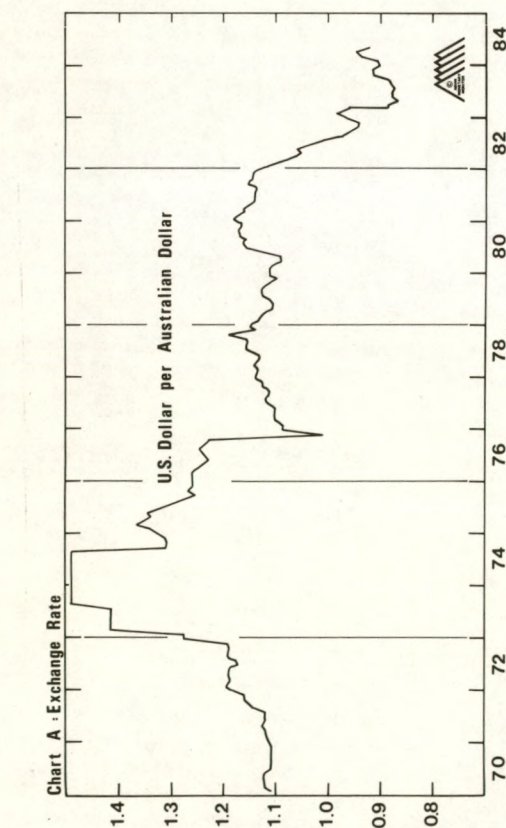
The true significance of Korea's new monetary control arrangements is perhaps best understood if one considers what might have happened in the Korean economy had the Bank of Korea retained the old pegged exchange rate regime. In 1980 and 1981 Korea experienced record trade and current account deficits and these deficits continued, although at a reduced level, during 1982. As a result of these external deficits the bank of Korea's net foreign asset holdings have declined substantially (refer to Chart 2) since mid-1980. If the Bank of Korea had opted to adhere to a fixed exchange rate policy it would almost certainly have been faced with either an unprecedentedly severe recession - which would have undoubtedly have been deeper and of a longer duration than the one which actually occurred - in the domestic economy or a series of large devaluations in the external value of the Won. The latter approach would probably have undermined overseas confidence in Korea at a time when its external indebtedness was the subject of critical examination and, more importantly, the Korean authorities would have faced considerable difficulty in gauging the appropriate size of each devaluation. In the light of particularly rapidly changing financial conditions in the US, the Korean authorities would have been faced with a major task in judging the Won exchange rate appropriate to i) prompting a recovery in Korea's trade competitiveness without unduly prolonging a domestic recession and ii) preventing a resurgence in domestic inflation.

By design, the monetary system which has been adopted by the Bank of Korea circumvents both these problems. By implementing direct control over domestic monetary growth the Bank of Korea can realistically expect to attain whichever inflation rate objective the Korean government chooses to establish. By allowing the Won to float relatively freely on the foreign exchanges, the Korean authorities can realistically anticipate that the exchange rate will adjust to levels which effectively enable net inflows or outflows on capital account to be counterbalanced by current account deficits or surpluses.

FORECAST : It has been well recognised that the Korean economy is capable of very rapid real growth when compared with more developed economies. What may not be so well understood is that as a result of the Bank of Korea's newly implemented monetary measures, the likelihood that these high rates of real growth will henceforth be accompanied by very moderate rates of inflation has been increased.

Korea is unique, in the Asian Pacific Region, in having adopted a reliable system of monetary control so comparatively early in its economic development. Provided the authorities use the new system to its full advantage, and maintain monetary growth at a low, stable level this policy change will certainly become of immense benefit to long term investors in the Korean equity market.

AUSTRALIAN DOLLAR



On December 11th 1983 the Australian authorities altered fundamentally their policy towards the Australian dollar exchange rate. Prior to this date the Australian dollar had been a managed currency. Henceforth, the Australian dollar is to be allowed to float freely on the foreign exchanges. This change in exchange rate policy has led to considerable volatility in the Australian dollar. Up until December 11th the Reserve Bank had utilised the exchange rate as a key instrument of monetary control. Thus whenever, as in the final six months of 1983, a large balance of payments surplus threatened (via the managed exchange rate policy) to bring above target domestic monetary growth the Reserve Bank stood ready to appreciate the external value of the Australian dollar. This, it was hoped, would reduce Australia's external surplus and lead indirectly to more moderate growth in the money supply. However in recent months, foreign exchange market participants have speculated heavily on the Reserve Bank's likely response to above target money growth. (M3 rose 13.4% in the year to December, compared with an official target range of 9%-11%.) Their purchases of Australian dollars often represented a private capital inflow to Australia, thereby swelling

the overall balance surplus and inducing upward pressure on local monetary growth. This prompted an official appreciation of the Australian dollar to a recent high of US\$0.9450. The decision to float the Australian dollar prompted immediate weakness in that currency in the days following the float as speculators covered their short term positions. However the Australian dollar has since recovered and appears to have stabilised at around US\$0.92.

The fundamental outlook for the Australian dollar this year is uncertain. On the one hand, investors must be concerned at the high levels of monetary growth in Australia during 1983: M3 continues to grow at above target rates (Chart E) whilst M1 growth has accelerated from 0.9%, year-to-year, in January 1983 to 15.6% in December. Easy liquidity has encouraged a strong recovery in the domestic economy but it underscores the potential for cyclically higher inflation as the business cycle matures. It also threatens the possibility of any further improvement in Australia's current account position (Chart B). Higher inflation may undermine confidence in Australian economic policy, particularly in the efficacy of the current Wages and Prices Accord, and would leave the Australian dollar vulnerable to larger current account deficits.

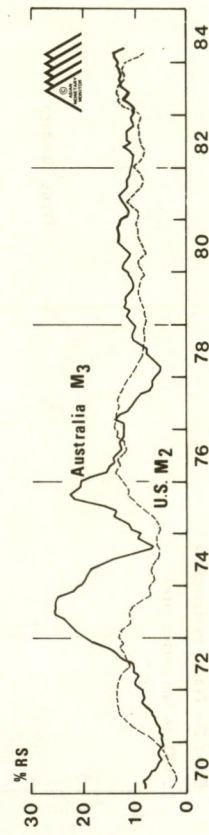
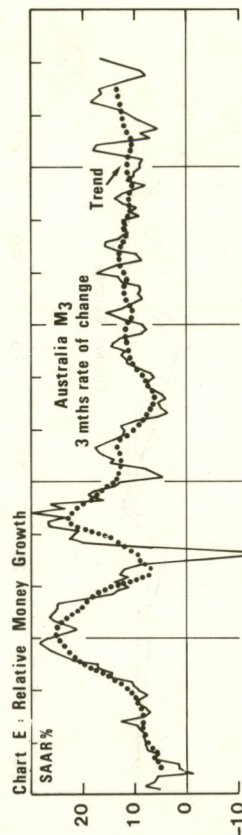
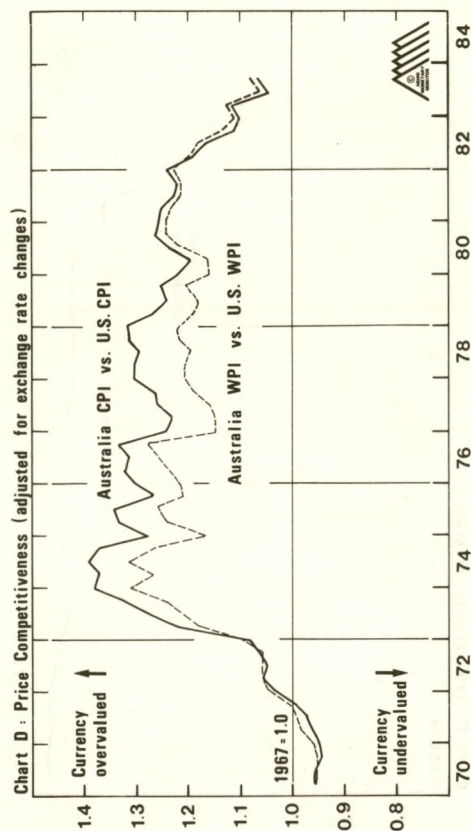
On the other hand, however, inflation in Australia is currently in cyclical decline (Consumer prices rose 8.6% in the year to December) following the 1982 recession, exports are firm and confidence in Australia's political leaders remains high. Thus it is likely that the Australian dollar will remain relatively firm over the next six months aided, perhaps, by seasonally higher interest rates in April and May. However this should not encourage a more sanguine longer term outlook for the Australian currency. If monetary growth is allowed to remain at current levels the Australian dollar will ultimately prove to be fundamentally weak.

ACTUAL FORECAST

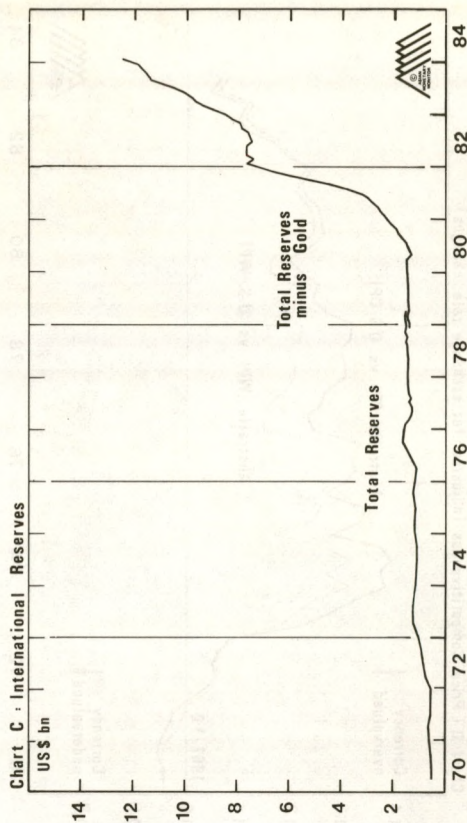
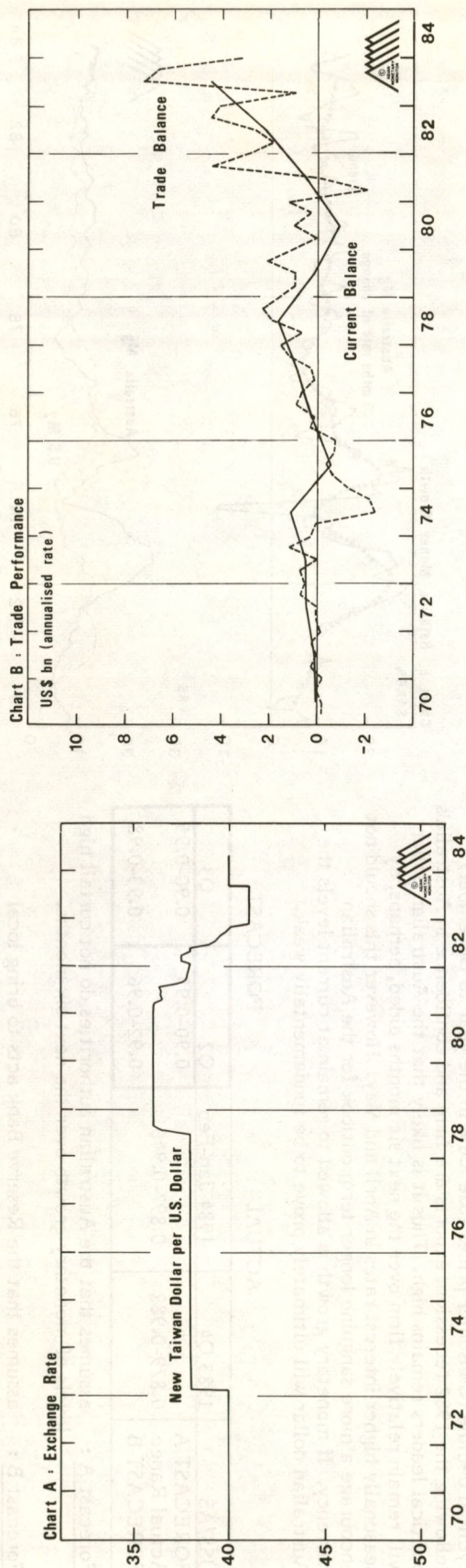
US\$/A\$	1983 Q4	1984 Jan-Feb	Q2	Q3
FORECAST A			0.90-0.95	0.90-0.95
Actual Range	0.879-0.982	0.897-0.946		
FORECAST B			0.92-0.96	0.93-0.98

Forecast A : assumes that the Australian authorities do not curtail high levels of monetary growth over the next six months.

Forecast B : assumes that the Reserve Bank acts to bring local monetary growth back to target in the near future.

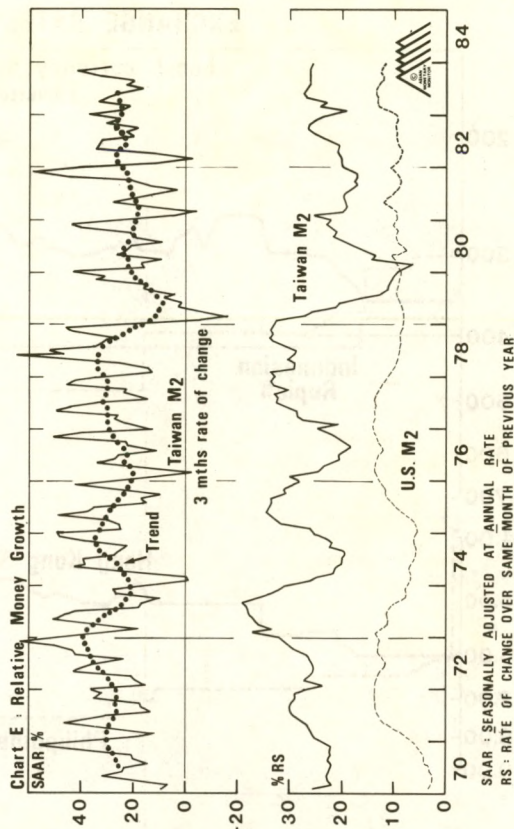
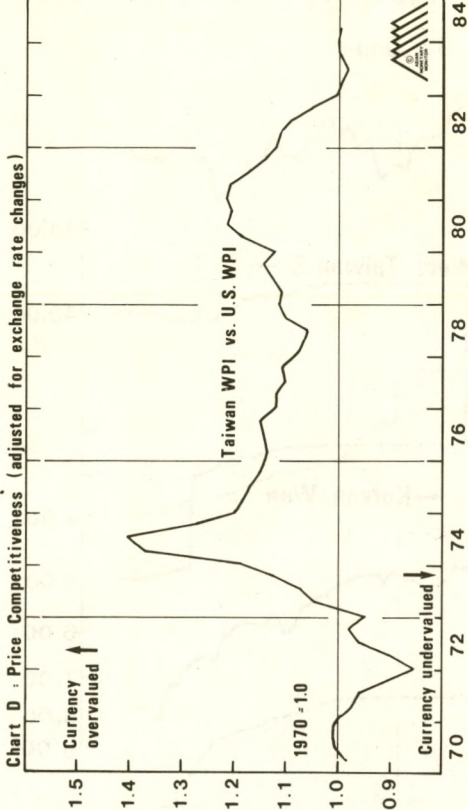


NEW TAIWAN DOLLAR



The New Taiwan dollar should continue to be regarded as a strong currency. It is very likely that the Central Bank of China will retain the N.T. dollar's existing parity of NT\$40 against the US dollar over the coming year.

The two economic factors which are most frequently associated with a formal devaluation of a pegged exchange rate are either a serious deterioration in the country's external account or discontent with the costs - in the form of reduced real growth in the local economy - of maintaining the existing exchange rate. It is clear that the Taiwanese economy has not suffered from either of these problems during the current business cycle. Chart B indicates the strong improvement of Taiwan's trade and current account position over the last two years. The trade surpluses recorded in 1983 were predominantly a consequence of a sharp revival in overseas demand for Taiwanese exports, with the value of exports rising by 32.5% in the year to November. The cyclical strength of Taiwan's external account has been reflected in a further rise in Taiwan's international reserve holdings (see Chart C).



The recovery in export demand has also contributed to a return to high levels of real growth in Taiwan's economy. Real GDP is estimated to have risen by nearly 8% in 1983 and is forecast to rise by a comparable amount this year.

One of the most striking features of the Taiwan economy in this cycle has been the success in reducing significantly domestic levels of inflation. Consumer prices actually declined by 1.1% in the year to January 1984 after three years - 1979, 1980 and 1981 - of double digit inflation. The slowdown in inflation since 1981 follows the severe squeeze in domestic liquidity during the first half of 1980 and the maintenance of historically low levels of monetary growth in 1981 and the early part of 1982. However the cyclical improvement in Taiwan's external account has, under a pegged exchange rate policy, led to upward pressure on domestic monetary growth over the last eighteen months. M2 growth has risen to levels which are comparable with those of the 1970s.

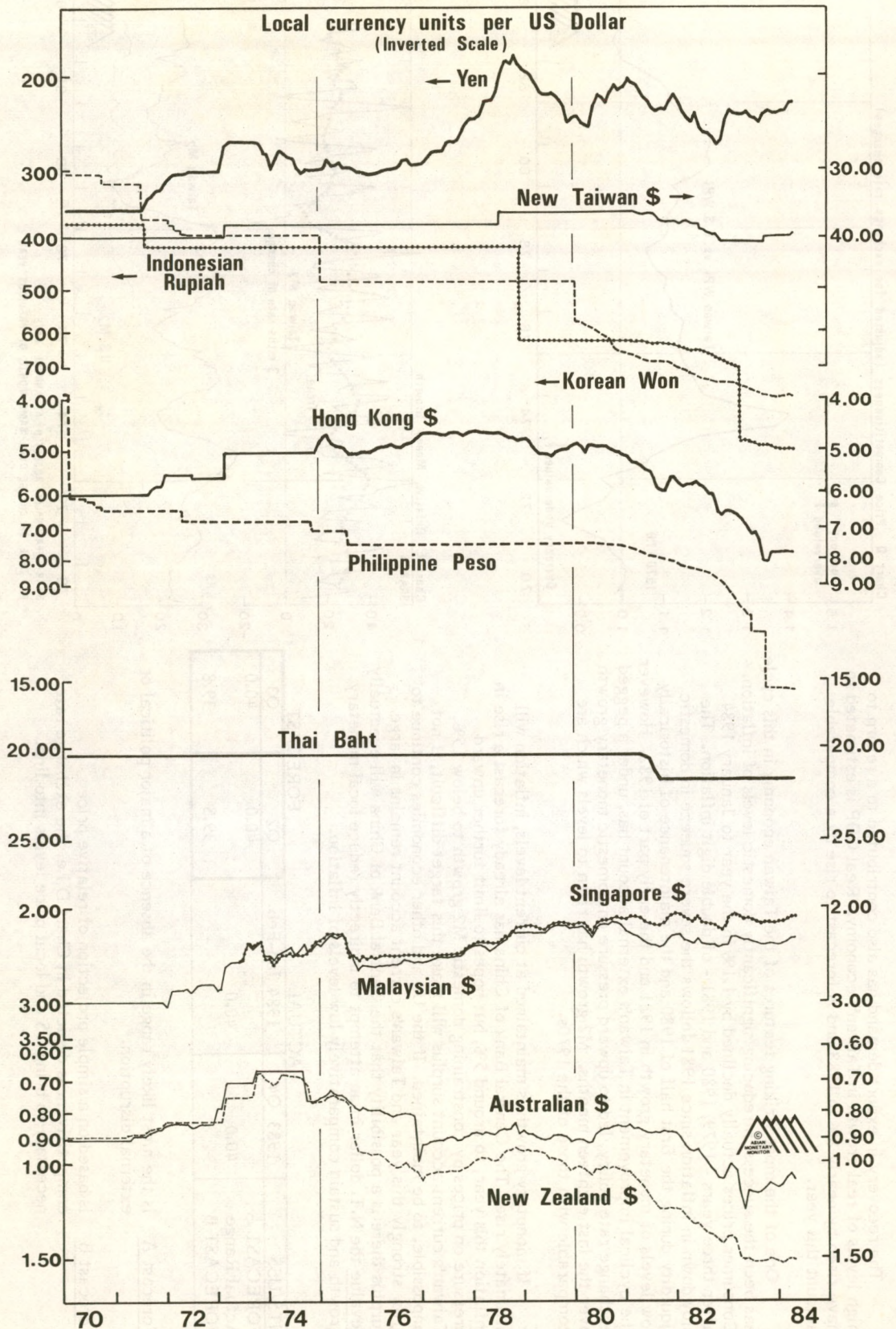
If monetary growth is maintained at current levels, inflation will ultimately rise. The Central Bank of China has already forecast a rise in inflation this year, to around 5%, but hopes to limit further upward pressure on prices by constraining domestic M2 growth to below 15%. Taiwan's current account surplus will make this target difficult, if not impossible, to be maintained. If the US and other economies continue to grow strongly this year and Taiwan's current account remains in large surplus there is a possibility that the Central Bank of China will eventually revalue the N.T. dollar in an attempt to indirectly reduce local monetary growth and sustain comparatively low levels of inflation.

NT\$/US\$	ACTUAL		FORECAST	
	1983 Q4	1984 Jan-Feb	Q2	Q3
FORECAST A			40.0	40.0
Actual Range	40.0	40.0		
FORECAST B			39.8	39.8

Forecast A is the most likely range in the absence of a major political or external disruption.

Forecast B is based on a simple projection of relative price competitiveness depicted in Chart D i.e. the exchange rate necessary to bring US and local price levels into line.

EXCHANGE RATES IN THE FAR EAST

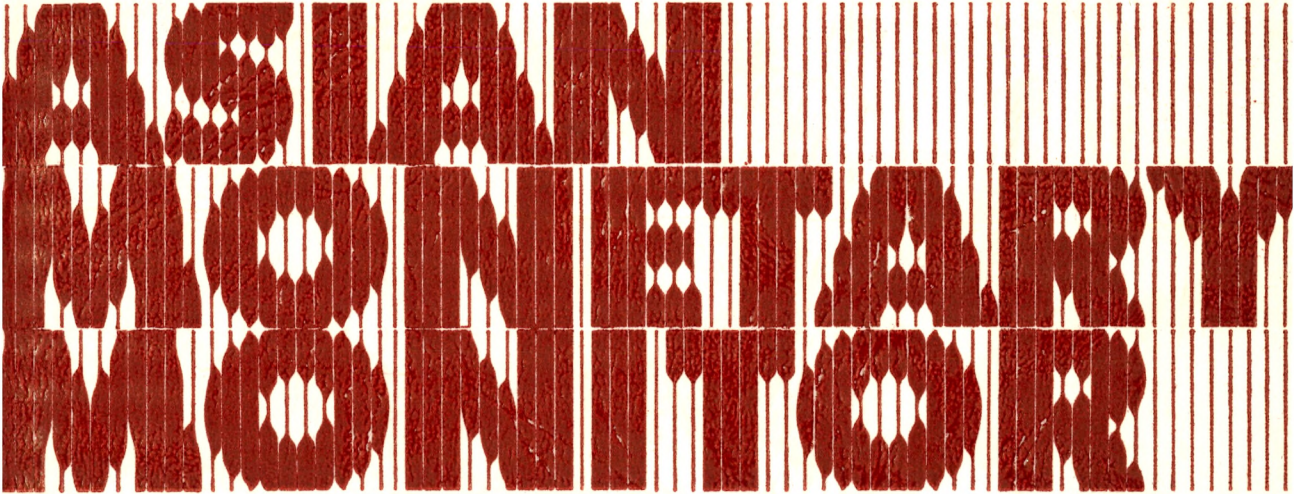




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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

THE JAPANESE EXPERIMENT IN MONETARISM, 1974 TO 1984*

The conduct of monetary policy in Japan since July 1974 contains many lessons for students of monetary theory. Broadly speaking the Bank of Japan has adopted a monetarist policy in practice, but has on the whole demurred from the use of monetarist rhetoric. To evaluate the achievement of the Bank of Japan since 1974 it is useful to distinguish between the strategy of monetary policy, broadly conceived to mean the adoption and control of an intermediate target variable such as the money supply and its relation to the behaviour of the economy, and the tactics of monetary policy meaning the detailed machinery of execution whereby the authorities succeed or fail in achieving their intermediate objective.

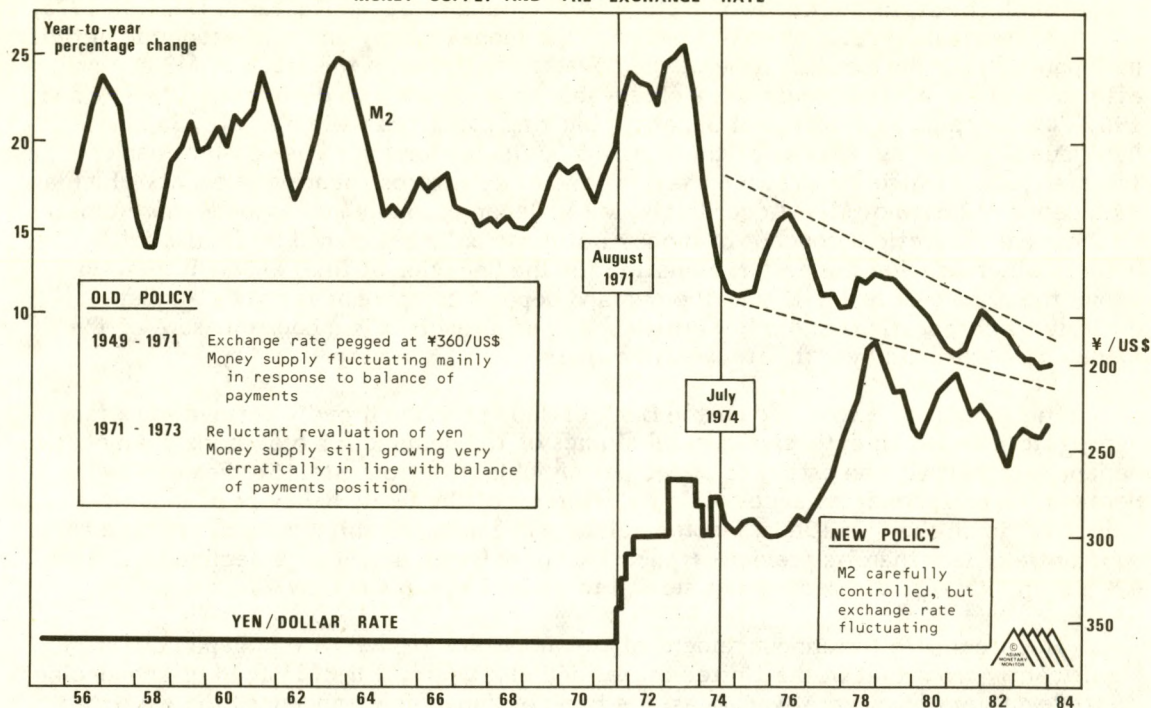
On the question of strategy the evidence from the Bank of Japan since 1974 provides powerful support for monetarist theory. On the detailed tactics of execution there is much about the Japanese experience which is unsatisfactory not so much from a monetarist standpoint, but from a wider free market viewpoint. This divergence partly explains the dichotomy between monetarist practice and the avoidance of monetarist rhetoric. However, these shortcomings do not impair the main conclusions. On the contrary, when those shortcomings have from time to time obstructed or been inconsistent with the attainment of broader strategic goals, reforms have been virtually forced upon the authorities so that gradually their tactics have been brought into line with their monetarist strategy.

Japanese Monetary Strategy, 1949 to 1974

In April 1949 the yen exchange rate was pegged at Yen360 per US dollar, and it remained rigidly fixed at this rate until August 1971. From 1971 to 1974 there were a series of changes in what was essentially a fixed rate, but always with the intention that Japan would return to a rigid parity. In theoretical terms, since the price or value of the yen was fixed, the quantity of money in Japan had to adjust to whatever level was consistent with equilibrium in the balance of payments. In practical terms this meant that the growth of Japan's money supply was determined by the overall state of the balance of payments, accelerating when there was a balance of payments surplus, and decelerating or declining when there was a balance of payments deficit. For economic activity and the inflation rate it meant that both were subjected to the 'dance of the dollar', rising in response to expansionary forces emanating from the USA, and falling in response to contractionary forces. In theory the Bank of Japan could have offset these disruptive influences to a degree, but in reality it had little room for manoeuvre as domestic capital markets were poorly developed allowing little opportunity for efficient sterilisation operations. In addition, as financial instability in the US increased in the late 1960s and early 1970s the difficulty of performing such operations would have been greatly magnified. Thus despite some partial offsetting by the Japanese authorities, the Japanese economy was increasingly subject to the growing disturbances affecting financial markets in the USA.

* This article has been submitted for publication in the Manhattan Report on Economic Policy by the International Center for Economic Policy Studies (ICEPS).

JAPAN
CHART 1
MONEY SUPPLY AND THE EXCHANGE RATE



Finally in the summer 1974, following M2 growth of 22% p.a. for the three years 1971-73 and consumer price inflation of 25% in 1974, the Bank of Japan decided to abandon the policy of maintaining a fixed exchange rate and attempting to maintain equilibrium in the balance of payments, and adopted instead a policy of controlling the broadly-defined money supply, M2. The shift in monetary policy accompanied an important political change: the expansionist Prime Minister Kakuei Tanaka who in 1972 had proposed a grandiose plan for "Remodeling the Japanese Archipelago" was forced to resign. The financially conservative Mr. Takeo Fukuda took over as Minister of Finance under the slogan, "Stable Prices and a Stable Economy". Having abandoned the constraint of a fixed exchange rate and having a favourably disposed Minister of Finance, the Bank of Japan was at last in a position to implement a stable monetary policy, independent from the United States.

Japanese Monetary Strategy, 1974 to the Present

The new strategy of the Bank of Japan was revealed for the first time in July 1974 when the authorities announced their intention to restrict the year-to-year growth of M2 in the period from October to December 1974 to the range 10-12%. (At the end of June 1974 M2 was 13.3% above its level in June 1973.) At the time of the announcement of the first set of monetary growth objectives few people were cognizant of the major change that was taking place in the conduct of policy, and generally the Bank of Japan has continued to maintain a low profile on the subject of the switch in policy. Since that time until the present the broad strategy of the Bank of Japan has been to control M2 (or M2+CDs since May 1979) within a narrow range while allowing the exchange rate to fluctuate fairly freely on the foreign exchange market. It is true that there continues to be occasional official intervention in the foreign exchange market, but this has never been permitted to compromise the attainment of the main target of policy, namely a specified growth rate for M2.

The basis for the Japanese authorities' choice of M2 is primarily empirical, but also theoretical. First, in the words of a study by the Bank of Japan Research Dept. in 1975, "Close statistical correlation exists between the money supply and real economic activity in Japan. This is particularly true of the covariation between the stock of M2 and prices after a time-lag of 2 to 4 quarters - observable through the two decades of 1955-64 and 1965-74". Second, as students of Japanese banking practices will be aware, Japanese individuals seldom use checks or checking accounts, preferring to use cash or bank transfer orders which are drawn on savings and other interest-bearing accounts which are included in M2 but not M1. Accordingly, M2 in Japan probably corresponds more closely to the ideal theoretical concept of money i.e. those balances owned by final wealth holders which provide the best explanation for the behavior of final expenditures. In Japan the drawback of M1 is that the demand deposit component is owned almost entirely by corporations and other entities, and as a result it is a poor measure of the money balances held by ultimate wealth owners.

The growth rate selected by the Bank of Japan for the broadly defined monetary aggregate is based on extensive careful studies of the demand for real money balances in Japan, together with an estimate of the permissible inflation rate. Studies of the demand for real money balances yield an estimate of the likely behavior of income velocity. Since the mid-1960s, income velocity in Japan has shifted, declining at a rate substantially less than its previous trend. Compared with an average decline of almost 4% p.a. in 1954-65, the decline has slowed to about 1% p.a. since 1966.

The procedure for announcement of the monetary growth rate in Japan differs significantly from that in the United States and elsewhere. First, instead of announcing multiple targets for several variables, the Bank of Japan only announces the expected growth rate for one variable, M2+CDs. Second, the growth rate is released as an expected growth rate, rather than as a specific 'target'. Third, the growth rate is announced and calculated as the year-to-year growth rate of M2+CDs in each quarter. Fourth, the announcement is made without fanfare at the end of each quarter with reference to the succeeding quarter.

The first feature - announcement of a single intermediate target variable - is clearly desirable and laudable. The second feature - deliberate avoidance of the word 'target' - is characteristic of central bank procedures the world over. In part it is designed to blur accountability and deflect criticism; in part it is intended to avoid being branded with the monetarist epithet. The third feature - computation of the growth rate over a whole year - simply conforms to orthodox practice in Japan where comparisons of economic data series are normally reported on a year-to-year rate of change basis rather than as month-to-month changes or as annualised rates for monthly or quarterly changes. The fourth feature - announcement of the expected growth rate at the end of each quarter for the succeeding quarter - combines aspects of the second and third, and undoubtedly makes it easier for the Bank of Japan to achieve the expected rate of growth, but by the same token it reduces the possibility of destabilising shocks or errors.

The net effect is that the Bank of Japan has compiled a remarkable record of never having deviated from its pre-announced figure for the expected monetary growth rate by more than one percentage point. The Japanese financial community has become so used to the predictability of the Bank of Japan's announcement and its success in achieving the predicted outcome that as an item of financial news the announced monetary growth rate is treated as no more than a minor formality. Changes in the official discount rate, by contrast, still attract far more attention despite their minimal impact on monetary trends.

TABLE 1
THE IMPACT OF LOWER MONETARY GROWTH
IN JAPAN ON GNP AND INFLATION

	<u>Average Rates of Growth (% per annum)</u>		
	<u>1970-74</u>	<u>1974-78</u>	<u>1978-83</u>
Money Supply	20.2	12.8	9.0
Nominal GNP	16.4	10.4	6.0
Real GNP	4.9	4.9	4.0
GNP Deflator	11.2	5.3	1.8

- Notes:
1. Money supply is quarterly averages of month-end data for M2 to April 1979, M2+CDs from May 1979, seasonally adjusted at annualised rates.
 2. Nominal and real GNP are quarterly data, seasonally adjusted at annual rates.
 3. Data for money supply are from June to June for each period; data for GNP and for the GNP deflator are for six months later, i.e. December to December in each case.

TABLE 2
THE IMPACT OF STEADIER MONETARY GROWTH
IN JAPAN ON GNP AND INFLATION

	<u>Standard Deviations of Quarterly Data</u>		
	<u>1970-74</u>	<u>1974-78</u>	<u>1978-83</u>
Money Supply	5.4	2.6	3.0
Nominal GNP	7.6	3.7	2.6
Real GNP	7.1	3.3	1.8
GNP Deflator	7.5	1.5	2.3

Notes: Data as in Table 1.

The results of the strategy of reducing and stabilising monetary growth in Japan since July 1974 are documented in the accompanying tables. Briefly they show that :

- (1) When sustained over a period of several years, lower monetary growth has reduced inflation in Japan from double-digit rates to about 2% p.a. It is still true that Japanese import and wholesale prices (which are heavily influenced by the prices of imports) fluctuate widely with the yen and with the business cycle abroad. However, whereas under fixed exchange rates such fluctuations affected the aggregate price level in Japan via monetary expansions or contractions, under a floating exchange rate regime with stable monetary growth such fluctuations only affect individual prices while the aggregate price level (i.e. the GNP deflator) remains stable.
- (2) More stable monetary growth has stabilised the growth rate of the economy. The most striking demonstration of this is that despite the two American recessions of 1980 and 1981-82, Japan did not experience a recession. There was some impact on the composition of Japanese GNP (e.g net exports declined), but only a minimal effect on aggregate GNP. However, the average real growth rate has remained close to 4%, and the variability of the growth rate has more than halved by comparison with the pre-1974 period.
- (3) A more tentative finding, not covered by the data in the tables but illustrated in the accompanying chart, is that more stable monetary growth has produced more stable capital markets. This is a more complex proposition to demonstrate because at the same time as the underlying conditions have become more stable, the Japanese authorities have been obliged to allow the markets for credit and capital to become more flexible. This leads us to the question of tactics.

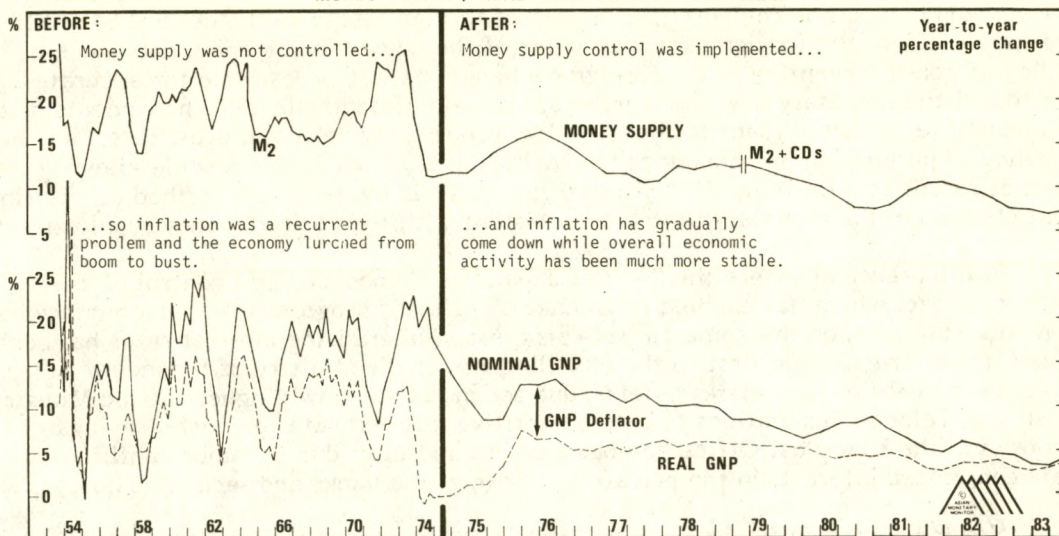
The Tactics of Japanese Policy since 1974

During the era of fixed exchange rates in Japan from 1949 to the early 1970s, credit-rationing was a normal feature of the financial markets. The Bank of Japan kept the official discount rate at artificially low levels - below free market interest rates - in order to direct 'cheap' credit to favoured industrial sectors via the banks which were its clients. The apparatus of credit rationing by the central bank was also extended to the commercial banks in the form of loan controls (known as "Window Guidance"), so that when the strategy of controlling monetary growth was first introduced in 1974 the tactics employed were to set loan ceilings consistent with specified monetary growth rates.

Strangely the method was initially successful, mainly because Japanese city banks' loans accounted for almost 85% of their total assets in 1974, and the banks subject to loan ceilings accounted for over 90% of the deposits included in M2. In addition, so long as the central bank offered extremely advantageous discount facilities compared with money market rates the city banks were most reluctant to transgress Bank of Japan guidance for fear of being penalised. Thus despite the worthy ends, the policy of money supply control started out by using what many monetarists would regard as reprehensible means. In other words, strategy was sound, but tactics were incompatible with the free market principles which are the hallmark of most monetarists in the non-communist world.

Gradually, however, the contradictions between the Bank of Japan's strategy and tactics have been reduced as strategic goals take precedence over tactical matters. At a theoretical level this is happening for a fundamental reason. According to monetary theory a central bank can control the money supply only if it regulates the quantity of high-powered money or monetary base. To do this it must allow the price or value of

JAPAN
CHART 2
MONEY SUPPLY, REAL GROWTH AND INFLATION

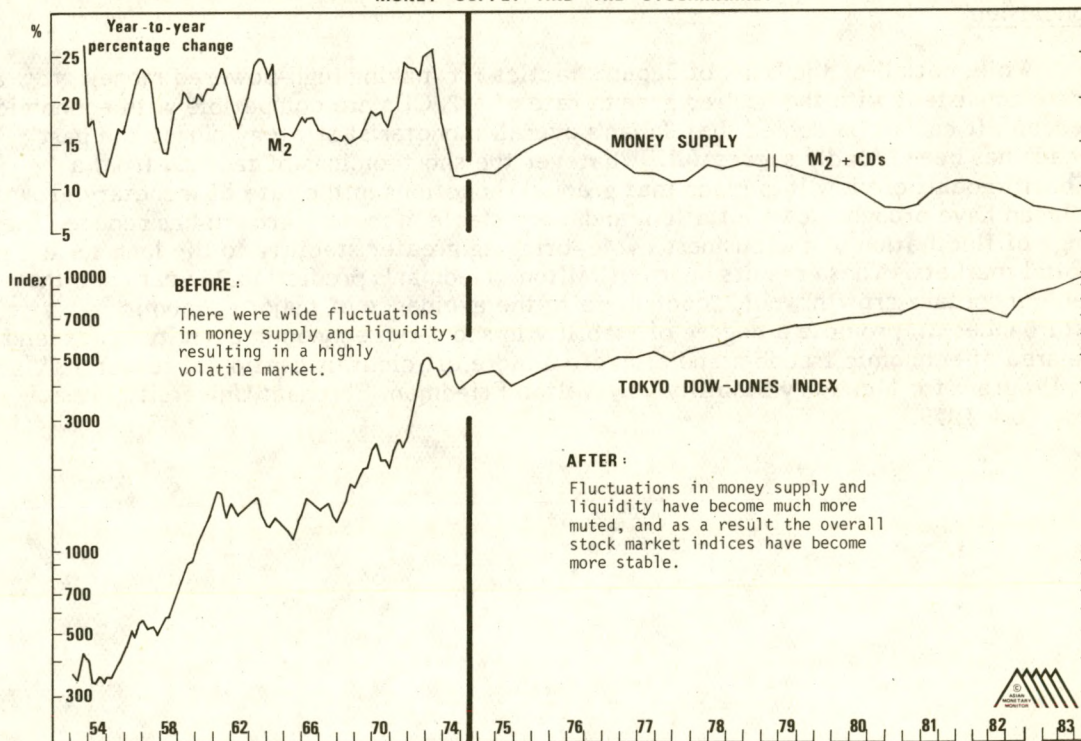


Until 1974 the Bank of Japan did not make any serious attempt to control the money supply. The combination of a fixed exchange rate and rigid domestic interest rates resulted in highly erratic monetary growth, and ultimately in the great inflationary blow-off of 1973-74 when overall prices (as measured by the GNP deflator) rose by 20% p.a. for over 2 years.

Since July 1974 the Bank of Japan has adopted a single policy objective: price stability, choosing M2+CDs as its intermediate policy goal. Simultaneously it adopted a policy of exchange rate flexibility and interest rate liberalisation, without which money supply control could not have been successful. Since 1975 the performance of the Japanese economy has been far superior to most other nations in terms of:

- (a) the sustained reduction in inflation, and
- (b) the stability of economic growth.

JAPAN
CHART 3
MONEY SUPPLY AND THE STOCKMARKET



money to adjust freely. Applying this to the price of high-powered money, the assets of the central bank corresponding to the monetary base can be divided into two kinds : foreign and domestic. The purchase or sale of foreign assets by the central bank will inevitably affect the foreign exchange value of the domestic currency, and hence a policy of non-intervention in the foreign exchange market is desirable for accurate control of the monetary base. The purchase or sale of domestic debt instruments or their equivalent (e.g. direct loans to the banks) will inevitably affect interest rates, and hence a policy of purchasing pre-announced quantities of such instruments while allowing market forces to determine domestic interest rates is the optimum method of ensuring that changes in the monetary base are consistent with the desired money supply growth.

In the practical sphere the Bank of Japan has abandoned rigid control of the exchange rate, which has enabled it to make significant progress towards monetary base control. However, on the domestic side progress in liberalising interest rates has been a much slower process due first to the unwillingness of the Ministry of Finance to sell government debt at free market yields, due second to the unwillingness of the Ministry of Posts and Telecommunications to set competitive interest rates on postal savings deposits in the huge Post Office Savings System, and third due to major conflicts between vested interests in the private sector (e.g. the banks and securities houses).

Nevertheless significant progress has been made, and interest rates in Japan are substantially freer than they were a decade ago. Savers and borrowers have a wider range of choice today than they did a decade ago. For its part the Bank of Japan adjusts the quantity of high-powered money far more by means of purchases and sales of a variety of domestic instruments, far less by means of changes in reserve requirements and changes in the official discount rate, and seldom resorts to credit rationing. Perhaps the most serious obstacle remaining to a wholly free market approach to tactics is the authorities' continued predilection for regulating the market shares of the city banks. Until the Bank of Japan is willing or able to allow 'free' competition as opposed to maintaining what it judges to be 'fair' competition among the banks it seems unlikely that it will move to fully impartial open market operations.

Conclusion

While not all of the Bank of Japan's tactics for making high-powered money grow at a rate consistent with the desired growth rate of M2+CDs are compatible with economic freedom, it cannot be denied that Japan's overall monetarist strategy during the past decade has been broadly successful. Whatever the shortcomings of tactics, from a scientific point of view it is clear that gradual reductions in the rate of monetary growth in Japan have brought down inflation, and more stable monetary growth has reduced the range of fluctuation of the business cycle, bringing greater stability to the long term capital markets. These results bear out Milton Friedman's prediction 25 years ago that stable monetary growth would "contribute to the avoidance of major economic disturbances promote a degree of stability in short-run economic activity expand the area of economic freedom and promote a more efficient utilisation of resources". ("A Program for Monetary Stability", by Milton Friedman, Fordham University Press, New York 1959.)

THE MONETARY CONSEQUENCES OF ARTIFICIALLY LOWER INTEREST RATES

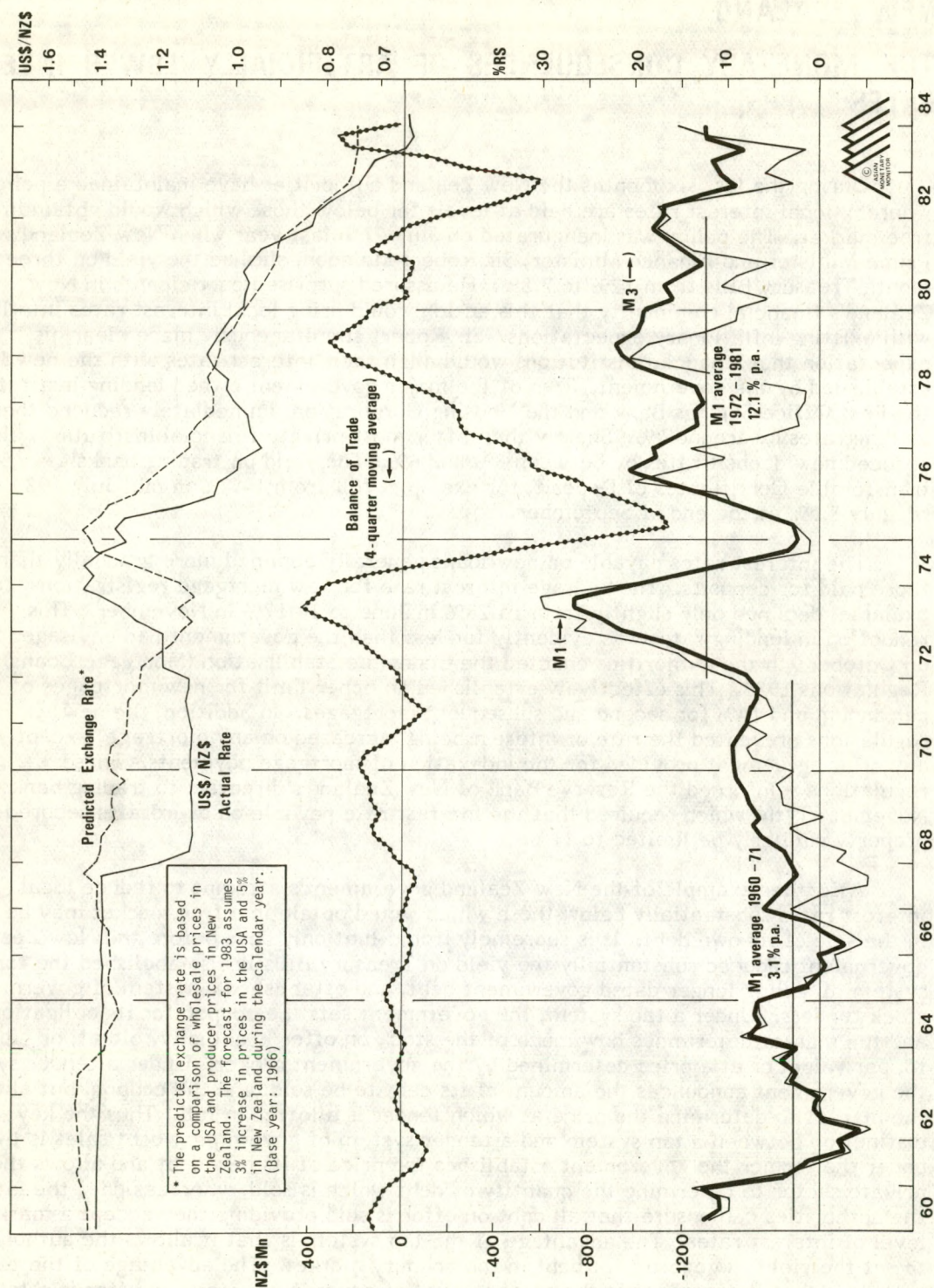
During the last six months the New Zealand authorities have maintained a policy whereby local interest rates are held at levels far below those which would obtain in a free market. The policy was inaugurated on July 27th last year when New Zealand's Prime Minister and Finance Minister, Sir Robert Muldoon, slashed the yield on three month Treasury Bills from 12% to 7.8%. He assured surprised participants in New Zealand's financial community that this action would bring local interest rates into line with existing inflationary expectations. Sir Robert simultaneously made clear his expectation that financial institutions would align their interest rates with the new levels established by the government. Two of the major government owned lending institutions, the Post Office Savings Bank and the Housing Corporation, immediately reduced their lending rates by around 4%. Shortly thereafter most private financial institutions also reduced new deposit rates by between 3% and 6%. The yield on trading banks' transferable Certificates of Deposit, for example, fell from 14.2% in mid July 1983 to roughly 8.5% at the end of September.

The interest rates payable on new loans generally declined more gradually than those paid for deposits. The average interest rate for new mortgage registrations, for example, declined only slightly from 15.28% in June to 14.17% in November. This reduction in lending rates was evidently far less than the government had envisaged for on October 7th the authorities enacted the Economic Stabilisation (Mortgage Loans) Regulations 1983. This effectively established an upper limit for new mortgages of 11% per annum and 14% for second and subsequent mortgages. In addition, the new regulations prevented the rate of interest being increased on any mortgage, except where any prior agreement provided for the indexation of mortgage payments. These regulations reinforced the Reserve Bank of New Zealand's directive to trading banks, on November 14th, which required that the interest rate payable on overdrafts secured by property similarly be limited to 11%.

A further example of the New Zealand government's attempt to reduce local interest rates substantially below those which would obtain in a free market may be seen in the sale of its own debt. It is supremely ironic that only days before the New Zealand government reduced substantially the yield on Treasury Bills it also abolished the tap system of selling longer dated government debt, and established a system of government stock tenders. Under a tap system, the government sets the coupon for its obligations and the market determines how much of the stock on offer is actually sold at, or close to, par value, or at a price determined by the government broker. Under a tender system the government announces the amount of its debt to be sold, and the coupon, but allows the market to determine the price at which tender is allotted in full. Thus the key distinction between a tap system and a tender system of government debt sales is that under the former the government establishes the price of its new debt and allows the private sector to determine the quantity of debt which is sold, whereas under the latter the authorities can ensure that all debt on offer is sold providing they accept a market level of interest rates. The advantage of the tap system is that it allows the authorities to set the yield on government debt in the primary market. The advantage of the tender system is that it ensures that the total amount of government stock on offer is sold into the primary market, providing, of course, that the authorities are prepared to allow the yield on their debt to be market determined. Thus the New Zealand authorities were plainly inconsistent in introducing a tender system for the sale of government debt at the same time that they were artificially regulating the level of interest rates in the domestic economy.

NEW ZEALAND

CHART 1: MONEY, TRADE AND THE EXCHANGE RATE



When Sir Robert announced the large reduction in Treasury Bill yields in July last year he simultaneously expressed his confidence that the coupons on forthcoming government bond tenders would be set nearer to 8%, down from the 14.0% level established in the free market prior to the government's intervention. The first two government bond tenders held after the decision to slash short rates resulted in primary market yields which were relatively close to the new reduced coupon levels set by the government. However any hopes that the government had established successfully a reduced level of bond yields in the New Zealand economy were quickly dashed. The third, fourth and fifth government bond tenders brought a range of bids which the authorities rejected because they entailed "excessively high" yield levels. The results of the first five government bond tenders are summarised in Table 1.

TABLE 1

New Zealand Government Bond Tenders

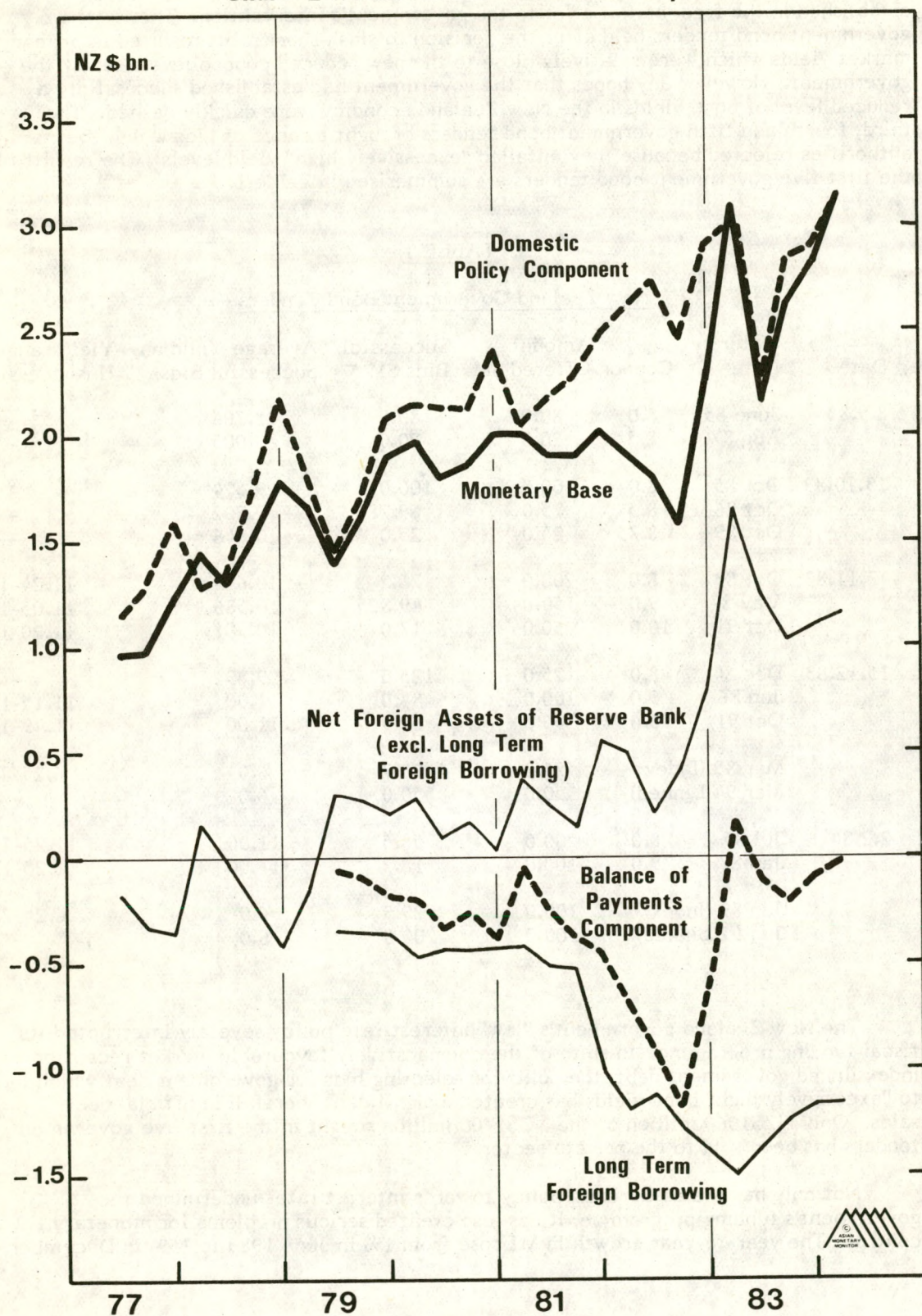
Tender	Date	Maturity Date	Coupon	Amount Offered \$M	Successful Bids \$M	Average Yield on Successful Bids	Yield range on Unsuccessful Bids
1	8.9.83	June 85	8.0	80.0	80.0	8.706	-
		Aug 87	8.5	20.0	20.0	9.005	-
2	13.10.83	Oct 85	8.0	100.0	100.0	9.524	-
		Oct 86	8.5	75.0	69.78	9.902	-
		Oct 89	8.75	25.0	25.0	10.646	-
3	17.11.83	Oct 83	8.0	200.0	76.2	10.644	11.24-17.5
		May 87	9.0	150.0	49.825	10.586	11.05-13.49
		Oct 91	10.0	50.0	17.0	10.901	11.20-12.99
4	15.12.83	Dec 84	8.0	125.0	125.0	9.89	-
		Jun 86	9.0	100.0	88.0	11.00	11.15-12.99
		Oct 91	10.0	50.0	19.9	11.00	11.49-12.48
		Mar 89 (Index		75.0	30.7	6.0	6.25-8.00
		Mar 94 Linked)		50.0	50.0	6.0	-
5	2.2.84	Jul 85	8.0	200.0	58.5	11.00	11.25-11.3
		Jan 87	9.0	100.0	18.7	11.00	11.25-13.0
		Jun 89 (Index		100.0	29.9	6.0	6.24-7.4
		Jun 92 Linked)		200.0	200.0	6.0	-

The New Zealand government's "low" interest rate policy severely interrupted its fiscal funding programme. In spite of the comparatively favourable market reception to index linked government debt, the policy of rejecting bids for government debt which led to "excessively high" bond yields has created a significant shortfall in official debt sales. Only NZ\$1060 million of the NZ\$1700 million sought in the first five government tenders has been sold to the private sector.

Not only has the authorities' policy towards interest rates undermined the government's funding programme, it has also created serious problems for monetary control. The year-to-year growth in M1 rose from 1% in June 1983 to 15% in December

NEW ZEALAND

Chart 2 : Sources Of The Monetary Base



1983. M3 growth has risen from 7% to 12% over the same period (see Chart 1). Unless the New Zealand government takes action to curtail swiftly the sources of higher monetary growth the year-on-year increases in M1 and M3 are likely to rise dramatically over the next several months. Since the government's decision to reduce New Zealand's interest rates below the levels which would obtain in a free market, the annualised increase in M1 has surged to 27% whilst the annualised growth in M3 during the second half of last year approached 22%.

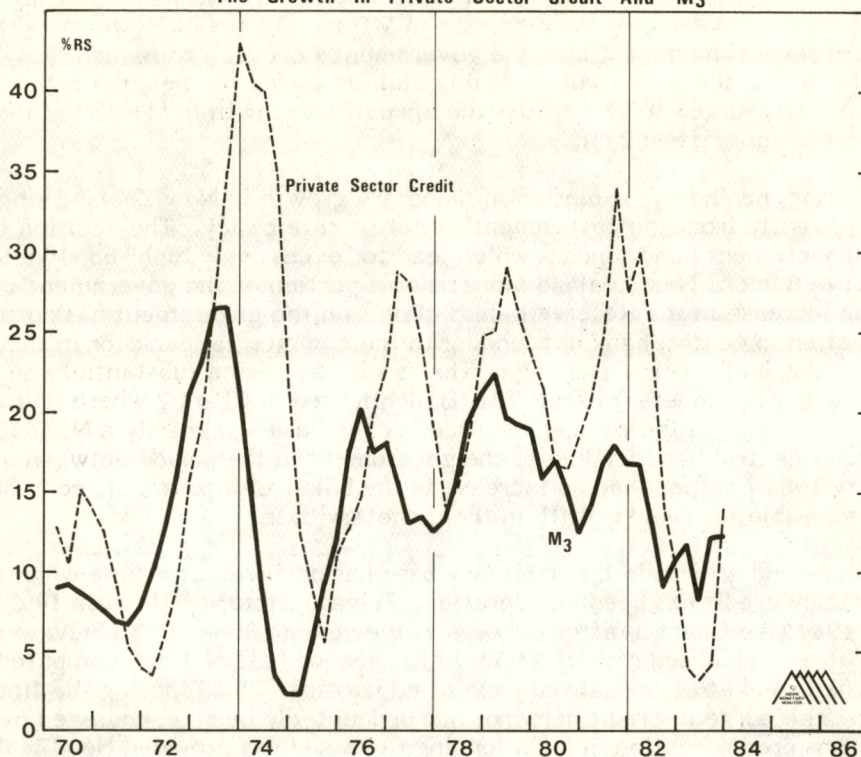
The factors behind the explosion in monetary growth in New Zealand since July last year follow directly from the government's interest rate policy. The decision to reject bids at the government bond tenders which lead to "excessively high" bond yields has led to the Reserve Bank of New Zealand monetising a portion of the government's fiscal deficit. The increase in the Reserve Bank's claims on the government has not been offset by any reduction in central bank net lending to the commercial banks or in the Reserve Bank's net holdings of foreign exchange. The result has been a substantial rise in New Zealand's unadjusted monetary base. This is highlighted in Chart 2 where it is apparent that it has been a rise in the domestic sources of the base - primarily a NZ\$650 million increase in net central bank lending to the government in the period between June 1983 and February 1984 - rather than an increase in the balance of payments component, which is responsible for rapid growth in the monetary base.

The increased growth in the monetary base has occurred at a time when the demand for bank credit has been accelerating. Private sector credit rose 14% in the year to January 1984 (see Chart 3) after only 3% in the year to June 1983. Private sector credit rose at an annualised rate of 23.5% in the second half of 1983, compared with 4% in the first half, and at an annualised pace of no less than 28.8% during the final quarter of the year. This surge in credit demands has undoubtedly been encouraged by the government inspired reduction in local lending rates and has provided New Zealand's commercial banks with a strong incentive to expand the size of their balance sheets. The result of this has been very rapid growth in New Zealand's monetary aggregates.

Since mid 1982 the New Zealand government has implemented a Prices and Incomes policy for the purpose of "freezing" price and wage increases. This policy, combined with a substantial decline in domestic monetary growth during 1982 and the first half of 1983, has encouraged a cyclical decline in inflation in New Zealand. Consumer prices rose 3.6% in the year to December, after rising by 17.0% in the year to June 1982. Over the last six months the New Zealand authorities have rightly become concerned that the sharp rise in monetary growth and credit expansion will undermine its objective of sustained low rates of inflation. Their concern has been intensified because the government has already promised to terminate the price "freeze" on March 1st this year and to replace it with a Price Surveillance System, which will allow companies' moderately greater flexibility in increasing output prices.

However, as a consequence of their decision to maintain interest rates at an artificially low level, the authorities are severely hampered in the application of any orthodox instruments of monetary control. Instead, the New Zealand monetary authorities have relied increasing on credit expansion "guidelines" for the local trading banks and finance companies. These "guidelines" purport to limit the expansion of credit to the private sector to a maximum of 1% per month. In practice, these "guidelines" have failed to limit the expansion in trading bank and finance company assets. The Reserve Bank's warning that such lending would be "closely monitored" has been largely ignored. Loans and advances by New Zealand trading banks rose at an average monthly rate of 1.5% during the second half of 1983, and authorised, but unexercised, loans by the trading banks rose at an annualised rate of 46% over the same period.

The Growth In Private Sector Credit And M3



The monetary authorities' response to the surge in bank lending and to the substantial increase in unutilised bank and finance company credit was to raise the trading banks' reserve asset ratio and to increase finance company and building society Public Sector Security Ratios. The objective of these measures was to restrain the growth of private sector credit to within the officially prescribed guidelines by artificially stimulating the banks' demand for public sector obligations. On December 16th the New Zealand Minister of Finance, Sir Robert Muldoon, announced that public sector security ratios applying to finance companies and building societies were to be increased. The finance company government securities ratio was to rise from 20% to 25% whilst the building society public sector ratio requirement was to rise by three percentage points to 19%. In announcing the measures, Sir Robert emphasised that both the finance companies and the building societies have been warned repeatedly that if their monthly lending exceeded one percent then ratio increases would be imposed. He said, "The Government is not prepared to tolerate lending growth rates which put in jeopardy the gains made from the (prices and wages) squeeze."

However the rapid expansion in finance company balance sheets continued during December, when deposits increased by 4.7% and finance company lending rose by 3.9%. On January 27th Sir Robert again increased finance company government securities ratios by an additional five percentage points, to 30%. Sir Robert explained the measure by saying, "the strong lending growth by finance companies indicates clearly that they have ignored the credit guideline, and their intense competition for deposits implies that they intend to continue to ignore that guideline. If they think that I will permit that rate of deposit growth to be translated into private sector credit growth then they are very much mistaken. (Our emphasis) If this second ratio increase does not convince the finance companies that their deposit and lending policies should be rapidly and substantially moderated, additional measures will be taken."

Trading bank reserve asset ratios have also been raised steadily over the last eight months, from 16% in June 1983 to 29.5% in February. In announcing the most recent increase in trading bank reserve ratios the Minister of Finance commented that he "was alarmed at the way trading bank credit limits grew during the latter half of 1983". Sir Robert added "They grew by 11% over that six month period. This ratio measure should indicate to the banks that I will not passively allow the high level of unutilised credit limits that they have created to be turned into actual lending".

These measures to limit the expansion of financial institutions balance sheets are unlikely to prove to be effective: they attack a symptom of fundamentally easier monetary conditions - strong growth in private sector credit demands - rather than addressing the causes of the surge in monetary growth which are artificially depressed interest rates resulting in strong growth in the monetary base. Unless the New Zealand authorities permit local interest rates to rise to free market levels, base money will continue to expand at an excessive rate. This will create the potential for further substantial increases in monetary growth. The authorities may well attempt to hinder further acceleration in domestic monetary growth by imposing yet higher reserve ratios on the trading banks and increasing the public security ratios for finance companies and for building societies, but until they stem excessive expansion in the monetary base, upward pressure on monetary growth will remain.

FORECAST: New Zealand's experience over the last seven months provides an excellent example of the problems which arise when a country's monetary authorities attempt to control both the level of interest rates and the rate of monetary growth. In July 1983, New Zealand's Prime Minister and Finance Minister, Sir Robert Muldoon, decided to reduce substantially both short and long dated interest rates below the levels then obtaining in the market place. The result has been an explosion in monetary and credit creation which clearly threatens the government's long term inflationary objectives. The authorities have attempted to restrain excessive monetary growth by adding a further layer of legislative constraints to New Zealand's already heavily regulated economy, and by threatening "additional measures" if local financial institutions do not limit growth in their balance sheets. These actions have not stemmed the trend towards higher monetary growth because they do not address its source: the rate of growth of base money in New Zealand is excessive and will remain so until such time as the authorities abandon their artificially low interest rate policy.

Although the New Zealand government has placed great emphasis on trying to ensure that low interest rates are maintained - including legislated ceilings on interest rates - its concern about the consequences of this policy (excessive monetary growth) have forced the authorities to compromise their primary objective. Interest rates in New Zealand have generally risen since September last year! This trend is evident in New Zealand's bond market (see Table 1) where the primary market yield on government debt maturing in 1985 rose from 8.706% at the first bond tender in September 1983 to 11% at the tender held in February this year. The primary market yield on government obligations maturing in 1987 rose from 9.005% to 11% over the same period. The same trend is apparent in the commercial paper market where the offered rate on ninety day commercial bills has risen from 9.8% in October 1983 to a current level of approximately 13.6%. In their efforts to limit both the level of interest rates and the levels of monetary and credit growth the New Zealand authorities have failed on both counts.

Although the New Zealand economy is beset by legislative and executive controls on announced increases in product prices - through the Price Surveillance System - any continuation of the artificially low interest rate policy will ultimately bring about significantly higher levels of inflation. In the final analysis the New Zealand government will likely be forced to react to this by implementing orthodox anti-inflationary policies. This in turn will entail a decision to abandon the low interest rate policy. Table 1 suggests approximate benchmarks - through the range of bid yields which proved

"unacceptable" in recent bond tenders - as to how much higher bond yields may have to climb in order to avoid further monetisation of the government's fiscal deficit. In New Zealand's context this might be thought of as a first step to stabilising monetary growth. A policy designed to reduce monetary and credit growth to more acceptable levels may well entail yet higher interest rates.

A THIRD YEAR OF HIGH MONEY GROWTH ?

Following on from a prolonged period of rapid monetary acceleration and easy liquidity in the banking system (AMM Vol. 7 No. 4), Thailand has experienced an eight month period of rising interest rates accompanied by a squeeze on bank liquidity. However, although the period since August last year has been characterised by observers of the Thai financial scene as a period of generally 'tight liquidity', in fact money growth has only recorded a small decline from the peak rates reached in the middle of last year. From a year-on-year rate of 26.7% in July 1983, M2 growth had declined to 23.3% by January 1984, still an excessively high rate of money growth when set against an economic growth rate of 6% and an inflation rate of 3%.

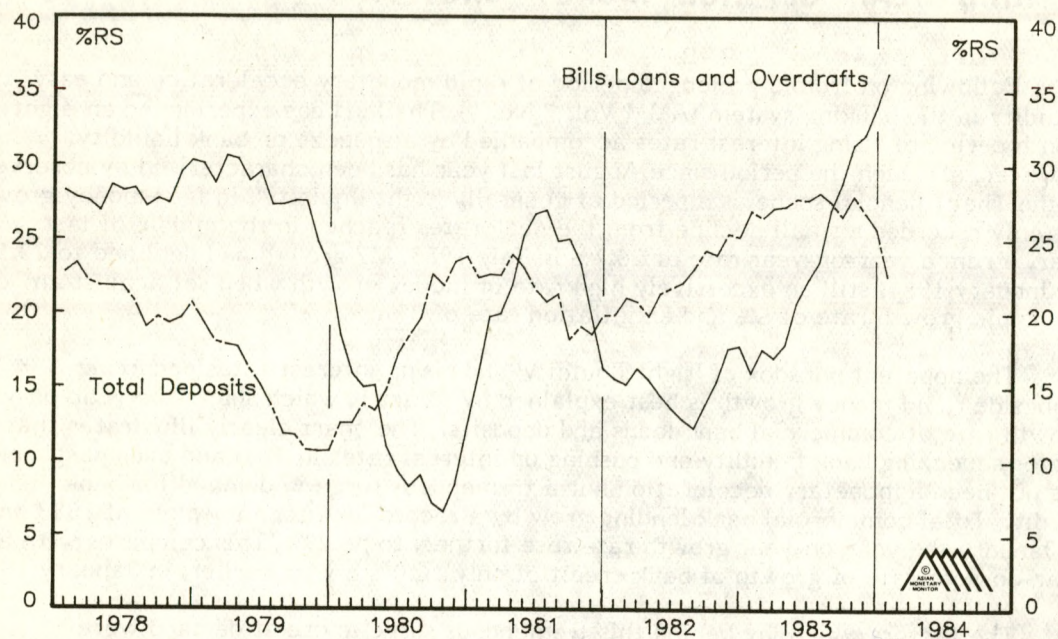
The apparent paradox of 'tight liquidity' and rising interest rates occurring alongside rapid money growth is best explained by Chart 1, which shows the year-on-year growth rate of commercial bank loans and deposits. The chart clearly illustrates that the factor squeezing bank liquidity and pushing up interest rates in Thailand over past months has not been a monetary deceleration but a tremendous surge in demand for bank credit. Total commercial bank lending grew by a record 34% for the whole of 1983 and in January the year-on-year growth rate rose further, to 36.2%. This compares with a year-on-year rate of growth of bank credit of only 16.0% a year earlier, in January 1983.

The factors which lay behind this tremendous surge in credit demand were essentially those considered in our last article on Thailand, namely a deterioration in the balance of payments acting against the background of Thailand's very rigid financial structure. Thailand's trade deficit more than doubled in 1983, to a record Baht 89 billion as exports fell by 7% in the wake of a poor crop season for 1982/83, and imports soared by 22% largely as a result of the strength of the economy. By far the worst period for the trade account was the first eight months of the year, and by August last year fears were growing that the Baht would have to be devalued. Along with the rising trend in overseas interest rates which accompanied the tightening of monetary policy in the USA, fears of a devaluation discouraged overseas borrowing by private enterprises and led to a further deterioration in the overall balance of payments.

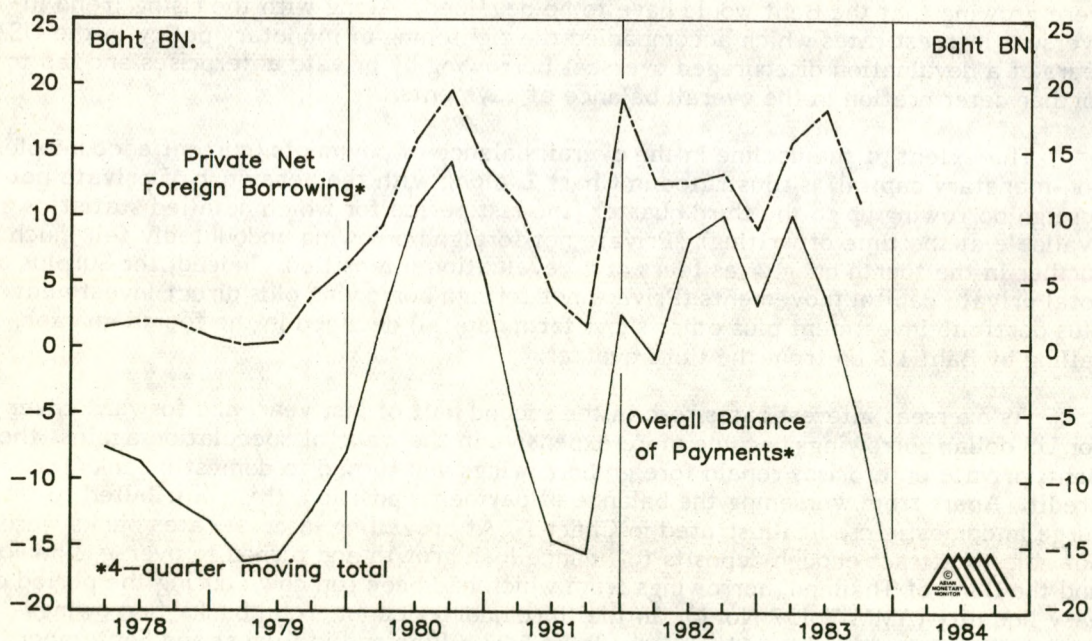
The extent of the decline in the overall balance of payments (current account plus non-monetary capital) is illustrated in Chart 2, along with the behaviour of private net foreign borrowing up to the third quarter (the last period for which detailed statistics are available at the time of writing). Private net foreign borrowing undoubtedly fell much further in the fourth quarter as fears of a devaluation intensified. Indeed, the surplus on total private capital movements (Private net foreign borrowing plus direct investment plus portfolio investment plus other short term capital) declined in the fourth quarter, falling by Baht 1.8 bn from the third quarter.

As overseas interest rates rose in the second half of last year, and forward cover for US dollar borrowings became more expensive in the wake of speculation against the Baht, private enterprises repaid foreign borrowings and turned to domestic banks for credit. Apart from worsening the balance of payments position, this contributed to the surge in domestic credit illustrated in Chart 1. At prevailing interest rates banks were not able to attract enough deposits to finance loan growth and turned to overseas banks and the Bank of Thailand, borrowings from which had been run down during the period of easy liquidity (AMM Vol. 7 No. 4). In the third quarter commercial banks' borrowings from banks abroad increased by a large Baht 5.23 billion and in August and September direct loans from the Bank of Thailand increased by Baht 1.17 bn, or from 0.5% to 0.8%

THAILAND
CHART 1: BANK LOANS AND DEPOSITS



THAILAND
CHART 2: PRIVATE NET FOREIGN BORROWING
AND THE BALANCE OF PAYMENTS



of total bank deposits. At the same time upward pressure on interest rates emerged and, following a rise in interbank rates in August, commercial banks raised the minimum lending rate by 1% at the beginning of September. At the beginning of December commercial banks raised deposit rates and raised loan rates again, putting the minimum lending rate at 17%, close to the maximum lending rate ceiling of 17.5%. With one year fixed deposit rates at the ceiling 13% rate, banks had no more scope to raise interest rates and pressed the Bank of Thailand to raise interest rate ceilings.

The Bank of Thailand at this time was caught in a dilemma, having to cope with the seemingly paradoxical situation of a chronic balance of payments deficit and still burgeoning monetary growth. Monetary base growth had not declined significantly because the foreign component of monetary base growth was supported by foreign borrowing by commercial banks (a 'below-the-line' item in the formulation of Thailand's balance of payments accounts), as they undertook to fund loan growth, while the domestic component of monetary base expansion was supported by commercial bank borrowing from the Bank of Thailand. At the same time, banks were selling government bonds to finance loans, making Central Bank bond sales to control monetary base growth virtually an impossibility. Thus, as an illustration, in the third quarter (which is a seasonally weak quarter), the monetary base declined by only Baht 614 million despite a Baht 9.3 billion balance of payments deficit. Net foreign assets of the Bank of Thailand declined by only Baht 2.87 billion, as they were supported by commercial bank foreign borrowing, and the effect of this decline on the monetary base was largely offset by Bank of Thailand's net claims on financial institutions and other items.

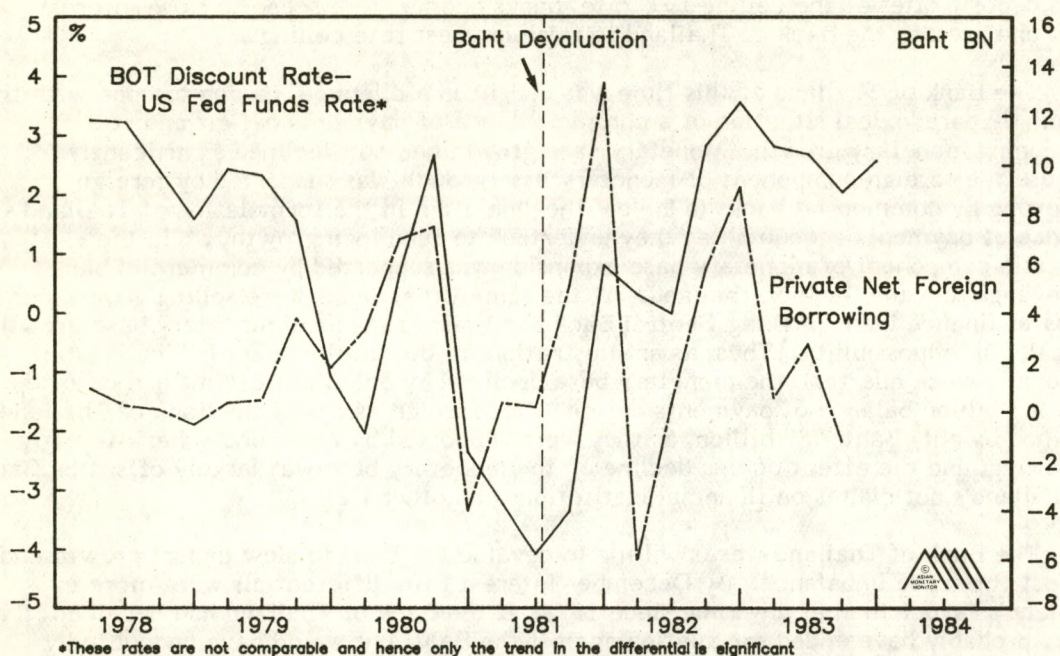
The Bank of Thailand was unwilling to devalue the Baht to slow import growth and correct the trade imbalance. By December interest rate differentials were more in Thailand's favour than at any time since 1978. If the Bank of Thailand had devalued, that would probably have ended speculation against the Baht, but would have undoubtedly encouraged a surge in private capital inflows and money growth such as occurred after the July 1981 devaluation (see Chart 3). Also, the Bank of Thailand was unwilling to raise interest rate ceilings because, apart from the perceived possible effect on the economy, once raised interest rates are very difficult to lower in Thailand due to rigidities in the financial structure. It was the unwillingness of commercial banks to lower interest rates below ceiling levels in 1982 which was the primary cause of the surge in monetary base and money growth during 1982 and early 1983 (see AMM Vol. 7 No. 4).

In the event, between December and early March this year the Bank of Thailand and Ministry of Finance introduced a patchwork series of measures designed to correct the trade imbalance and slow money growth. On December 9 the Central Bank took the necessary step of raising the discount rate by 1.5%, taking the rate for first tier borrowings at the discount window back up to 13%. Then, at the end of December, the Bank of Thailand took further measures to control money growth and limit imports. The most important of these measures were an increase in the amount of government bonds that commercial banks must hold as a proportion of deposits from 10% to 14%, and the introduction of controls on bank credit for imports. The government bond measure was intended to raise the demand for government bonds, and thereby enable the Bank of Thailand to slow monetary base growth through additional sales of government debt. However, although banks may hold more government bonds as a result, the regulation will be of only limited help to the Central Bank in its attempt to control monetary base growth as long as interest rates remain too rigid.

More importantly, at the beginning of January the Bank of Thailand introduced total credit control measures. Under these measures the growth of commercial bank lending in 1984 is to be restricted to 18%, comprising 9% growth in the first half and 9% in the second half of the year. Credits for consumer goods, speculative stock piling and construction, along with imports, are to be further restricted. The selective nature of credit controls was extended further at the beginning of March when the Finance

THAILAND

CHART 3: INTEREST RATES AND PRIVATE NET FOREIGN BORROWING



Ministry introduced a two tier maximum lending rate ceiling. The interest rate ceiling on loans for imports, luxury consumer durables, and buildings was put at 19%, while the ceiling on loans for agriculture, manufacturing and exports remained at 17.5%. The interest rate ceiling on deposits of between three months and one year maturity was raised to 13%, to be the same as the ceiling rate on deposits of one to two years maturity.

Basically, the authorities have responded to the problems which have arisen from the inflexibilities of the monetary system by introducing more rigidities into the system in an attempt to control monetary growth. Thus, the Bank of Thailand is now left attempting to enforce credit controls while maintaining a fixed exchange rate against the background of a very rigid interest rate structure. It seems clear that the current arrangements will not last long in a volatile world environment and that ultimately there will be pressure on the authorities either to introduce further controls, such as controls on foreign exchange flows, or to move in the other direction, perhaps floating the exchange rate.

In the meantime, given that the exchange rate is pegged to the US dollar, a major problem remains the rigidity of interest rates. Rates in Thailand are generally so rigid that by the time they adjust to the changing world financial environment, it is often so late that an adjustment in the other direction would be more appropriate. With the benefit of hindsight, this can effectively be seen to have been the case in February of last year when, after seven months of trying, the Bank of Thailand finally managed to persuade commercial banks to lower deposit rates (AMM Vol. 7 No. 4), but at a time when the trade account had already begun to deteriorate and only shortly before the US Federal Reserve moved back to a tighter money policy. For the slightly longer term, the aforementioned move to raise interest rate ceilings on short term deposits is a small step in the right direction to solving this problem. As 'fixed' term deposits are not actually fixed from the depositors' point of view (being withdrawable on demand), previously

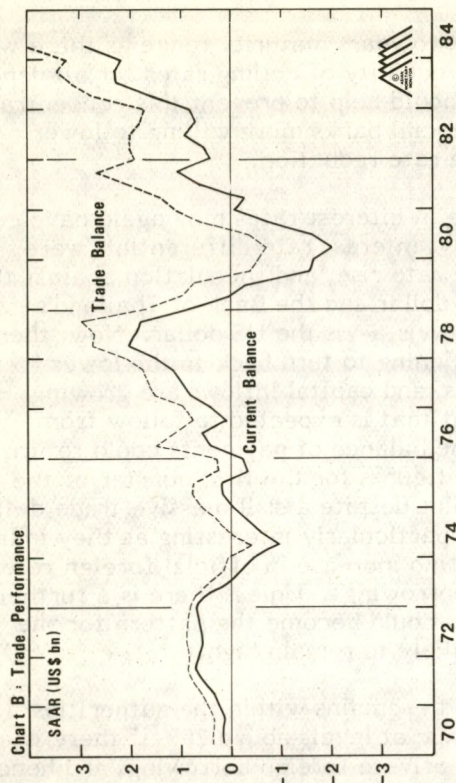
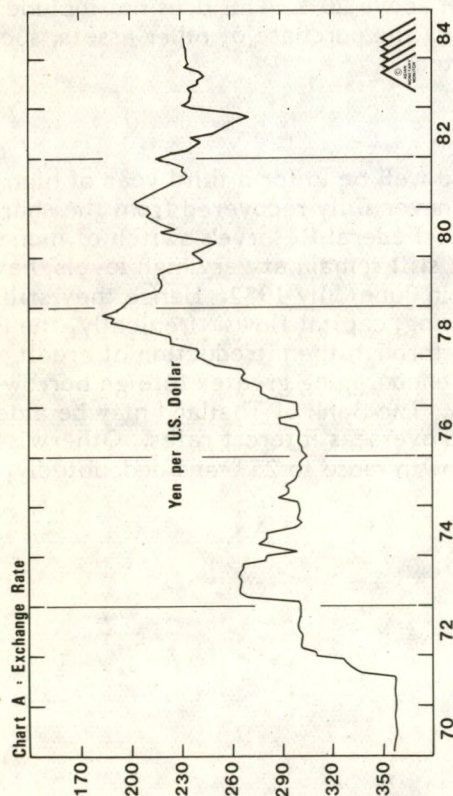
deposits tended to be concentrated in the one to two years maturity range as these were subject to higher interest rate ceilings. Now, the equality of ceiling rates for all deposit maturities between three months and two years should help to prevent this concentration of deposits in longer maturities, and make commercial banks more willing to lower interest rates when financial conditions warrant a rate reduction.

For the time being, however, the recent rise in interest rates may again have come at an inappropriate time. As mentioned previously, interest rate differentials were already very much in Thailand's favour before the rate rise, and speculation against the Baht was easing in the wake of the weakening US dollar and the Bank of Thailand's obvious commitment to the existing exchange rate vis-a-vis the US dollar. Now, there are clear signs that borrowers in Thailand are beginning to turn back to the lower interest rates available in overseas credit markets, and capital inflows are growing again. With the improvement in the trade account that is expected to follow from improved agricultural prices, this suggests that the balance of payments could return to surplus. Indeed, preliminary balance of payments figures for the first quarter of the year suggest that the overall balance was in small surplus despite a still massive trade deficit, of Baht 20 bn. Preliminary figures for March are particularly interesting as they indicate an overall balance surplus of Baht 2.29 billion, but no increase in official foreign reserves as banks paid back a similar amount of overseas borrowings. Unless there is a further significant rise in overseas interest rates then this could become the pattern for the year, which would suggest that money growth is likely to remain high.

The problem here is that even if credit growth remains within the authorities' 18% limit for the year, money growth could still continue at levels above 20% if there is a large balance of payments surplus, resulting from private foreign borrowing, and hence a high rate of monetary base growth. Commercial banks would react to easy bank liquidity by themselves paying back overseas borrowings, effectively replacing the foreign borrowings on their balance sheet with new deposits. A quick glance at the aggregate balance sheet for the commercial banks shows that if commercial banks reduced foreign borrowings by, say, Baht 10 bn, as they did in the year 1980 then the 18% credit growth limit could still be compatible with deposit growth above 20%. This does not include additional deposit growth which could be created by the purchase of other assets, such as government bonds, from the non-bank private sector.

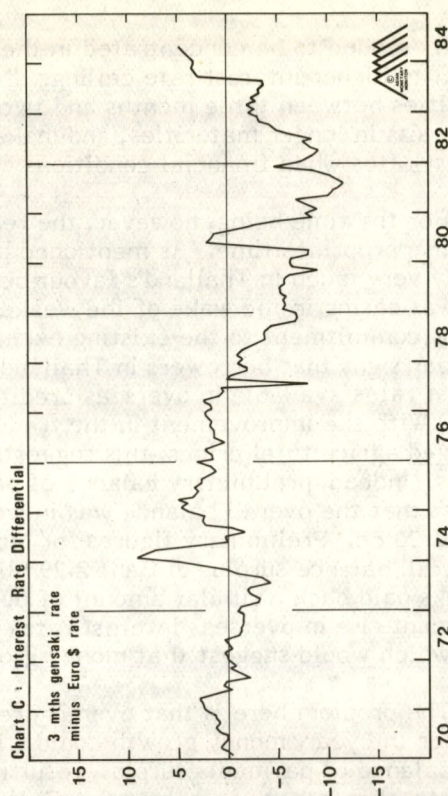
FORECAST : The conclusion is that Thailand could well be in for a third year of high money growth. In a monetary sense Thailand has never fully recovered from the sharp rise in US interest rates which accompanied the US Federal Reserve's switch of monetary policy in October 1979. Interest rates in Thailand still remain at very high levels, having never fully adjusted to the sharp drop in US rates in June/July 1982. Hence they still have the potential to draw in very large, destabilising, capital flows. Ironically, the Bank of Thailand's attempt to control monetary growth through the introduction of credit controls may only help to make matters worse by encouraging greater foreign borrowing and a still higher rate of monetary base expansion. The Bank of Thailand may be aided in its attempt to control monetary growth by rises in overseas interest rates. Otherwise, Thailand will experience a third year of money growth close to 25% and undoubtedly, ultimately, a very high rate of inflation.

JAPANESE YEN



The Japanese yen has remained firm over the last six months, rising to a new cyclical high against the US dollar and to all time highs against sterling and many European currencies.

In spite of the yen's relative strength, however, many investors are disappointed that the yen has not appreciated further against the US dollar. This disappointment arises from the view that in terms of relative inflation rates and current account performance the yen appears clearly to be "undervalued". Chart D suggests that the yen is anything up to 15% undervalued in terms of price competitiveness against the US dollar, which may imply an eventual appreciation of the yen to approximately ¥195. The underlying price competitiveness of the yen is highlighted in Chart B which records the burgeoning surpluses on Japan's trade and current accounts. Furthermore, current indications are that the trend in price competitiveness and in Japan's current account will continue to favour the yen this year. Japanese inflation is likely to remain stable at around 2% to 3% whilst inflation in the US is expected to rise to the 6% to 8% level by year end. So far, there are few signs of any forthcoming reduction in Japan's record trade surpluses: exports grew by 19.6% in the year to March, leading import growth of 12.7%.



Nevertheless, it is unlikely that the yen will continue to be independently firm against the US dollar. Japan's very large surplus on current account has been counterbalanced by large net long term capital outflows. In the first three months of this year Japan's current account surplus totalled US\$4.8 billion but heavy long term capital outflows have led to a basic balance of payments deficit of US\$1.1 billion. This compares with a total basic balance of payments surplus of US\$3.3 billion in 1983. The emergence of a basic balance of payments deficit in Japan is likely to impede further strength in the yen against other major currencies.

The increase in net long term capital outflows from Japan so far this year is undoubtedly partly a reflection of rising interest rates in the US, and market participants' perception that the Federal Reserve has tightened US monetary policy. However an additional factor leading to the increase in net capital outflows has been a decline in overseas net purchases of Japanese securities. During the fourth quarter of 1983, Japan's net overseas securities account was in surplus by US\$2.8 billion or roughly one third of Japan's net long term capital account deficit. However in the first two months of 1984 Japan experienced a net deficit on its securities account.

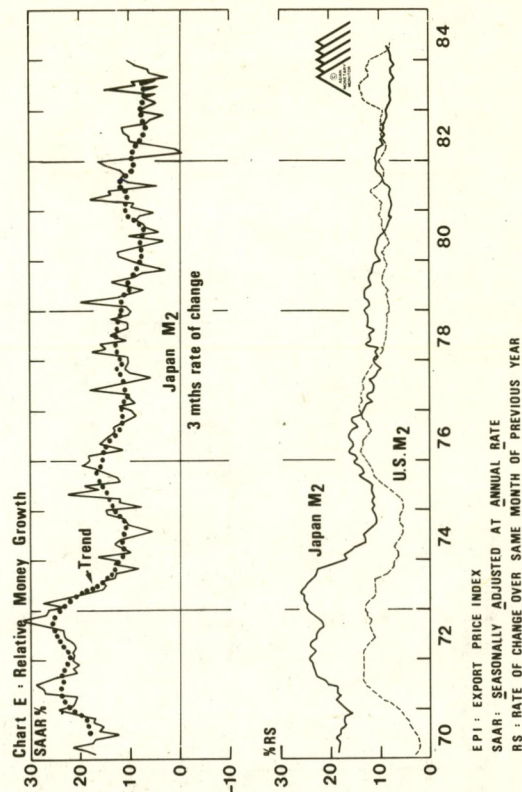
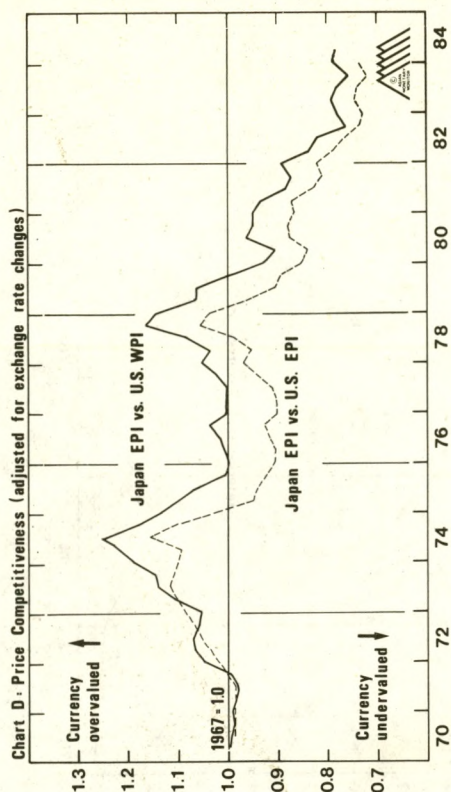
It is widely hoped that forthcoming measures to "internationalise" Japanese capital markets will promote greater strength in the yen. In fact, the implications for private capital flows to Japan in the wake of an additional liberalisation of local financial markets are ambiguous. Increased foreign company access to Japan's equity market, for example, may encourage greater net capital outflows from Japan.

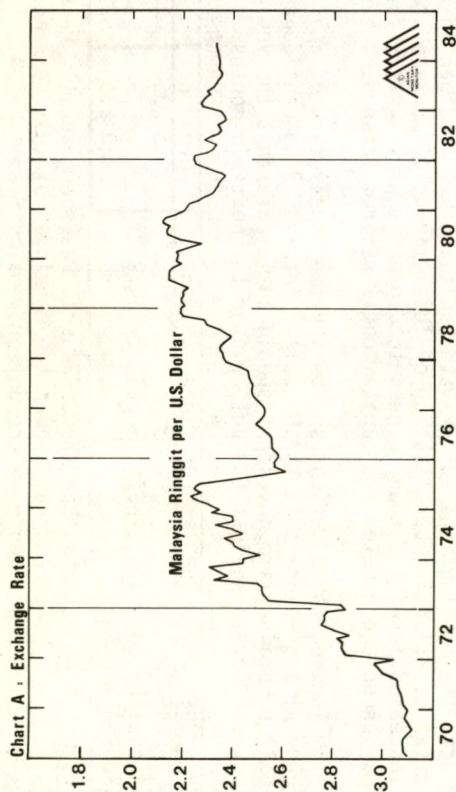
The yen would, of course, be a prime beneficiary of any generalised weakness in the US dollar but providing confidence in the dollar remains firm, investors should anticipate that the yen will hold current levels against the dollar over the next six months.

Yen/US\$	1983	ACTUAL		FORECAST	
		Q4 1984	Jan.-Apr. 1984	May-Jun. 1984	Q3 1984
FORECAST A				225-235	225-235
Actual Range	231.1-237.1		222.2-234.9		
FORECAST B				220-235	210-225

Forecast A assumes that the US Federal Reserve gradually raises interest rates over the remainder of this year and that confidence in the dollar remains firm.

Forecast B assumes that US interest rates remain close to current levels.

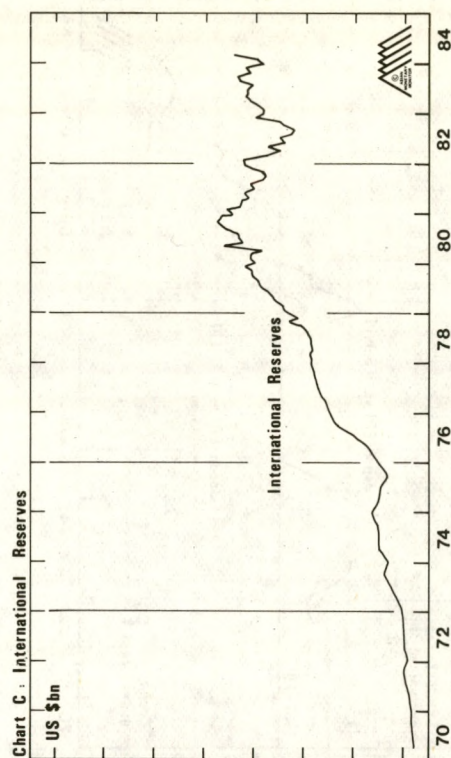
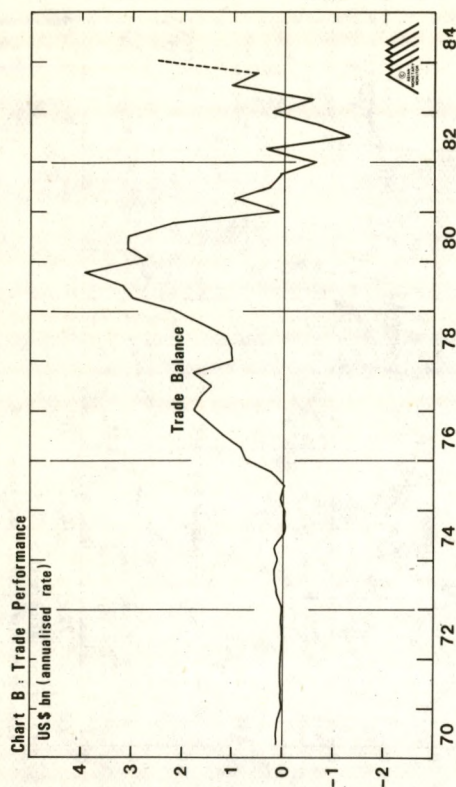




The Malaysian Ringgit has been a firm currency so far this year, appreciating slightly against a generally strong US dollar.

In our last forecast for the Malaysian currency (AMM Vol. 7 No. 5) we suggested that in the absence of a significant reduction in the size of the government's budget deficit, there was the potential for a marked rise in money growth if the Bank Negara Malaysia (BNM) failed to appreciate the exchange rate. This view was predicated on the assumption that continuing strong prices for Malaysian commodities, along with heavy government overseas borrowing to finance the budget deficit, could take the balance of payments into large surplus and lead to a monetary explosion similar to those that occurred in the 1973 and 1979 commodity booms (see Chart E).

However, it now appears that there is less likelihood of a significant appreciation of the Ringgit this year, as domestic and external developments have combined to reduce the potential upward pressure on money growth. Firstly, the government announced a sharp reduction in development expenditures for 1984 in the budget of October 21, which is expected to reduce the Federal government's deficit from 14% of GNP last year to 10% this year. The move to a



tighter fiscal policy should enable the government to reduce overseas borrowings from the very high levels (around M\$5 bn) of the past two years. Along with the continued deterioration in Malaysia's net balance on services, this fall in official capital inflows will partly offset the expected improvement in the trade balance and prevent the overall balance of payments surplus from rising markedly.

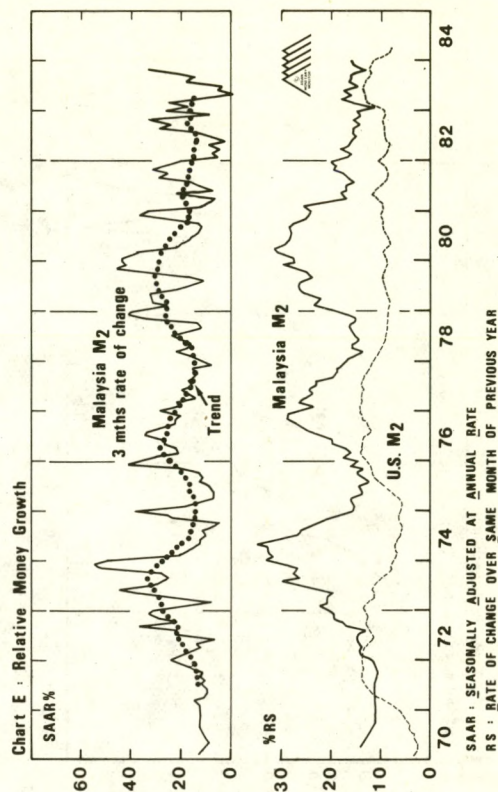
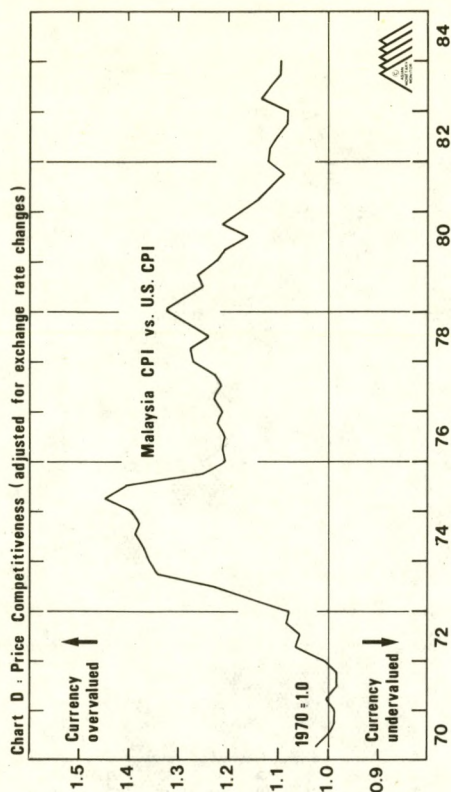
The second factor is that Malaysian commodity prices now appear less likely to rise significantly, at least during the course of this year. While the current price of palm oil is sharply higher than last year's average (palm oil tripled in price between June 1983 and January 1984) other Malaysian commodities have made little headway since the second quarter of last year. Rubber has recently fallen in price and timber is also suffering from fears of a slowdown in the US economy. Thus, whilst Malaysia's trade surplus is likely to continue improving this year as the trade account benefits from LNG exports, the improved performance of manufactured exports and higher oil output, there is as yet little danger of a commodity boom induced monetary explosion such as occurred in 1973 and 1979.

To summarise, given expected trends in the balance of payments the BNM is likely to feel that the current exchange rate will continue to imply adequate liquidity to sustain the economic expansion without inflationary consequences. Hence, unless the US dollar collapses there is at present little reason to think that the Ringgit will trade far from its current level against the US currency in the near future.

M\$/US\$	ACTUAL			FORECAST	
	1983	Q4	1984 Jan.-Apr.	May-June	Q3
FORECAST A				2.26-2.32	2.26-2.32
Actual Range	2.323-2.348	2.2825-2.343		2.60	2.60
FORECAST B					

Forecast A The most likely exchange rate in the absence of a major political or external disturbance.

Forecast B is based on a simple projection of price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line.



PHILIPPINE PESO

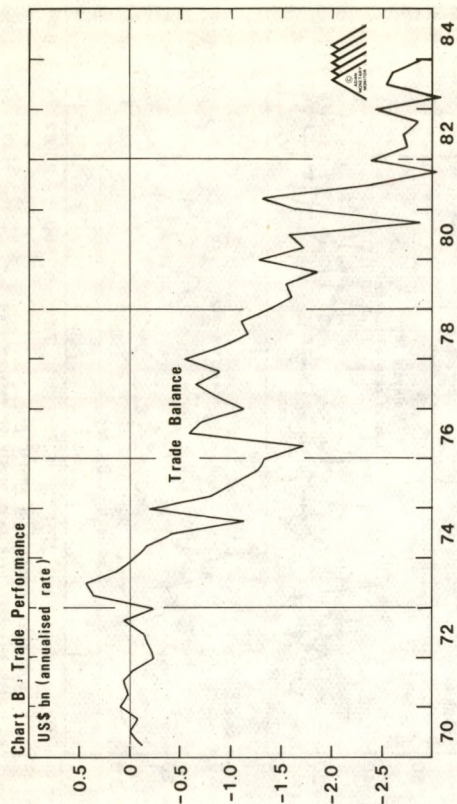
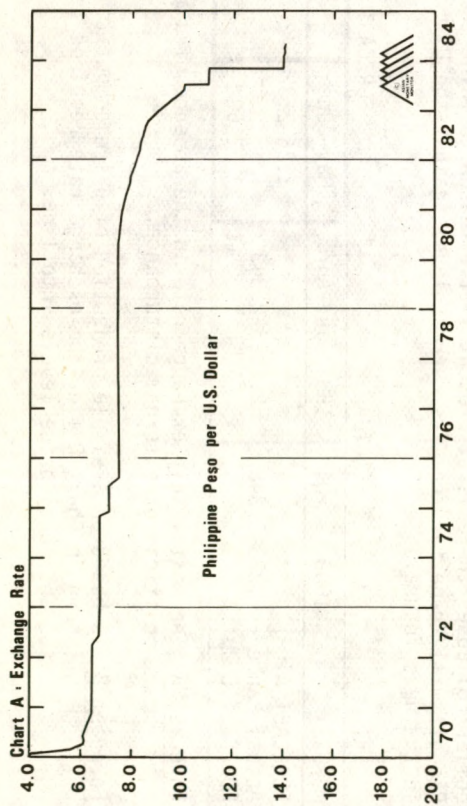
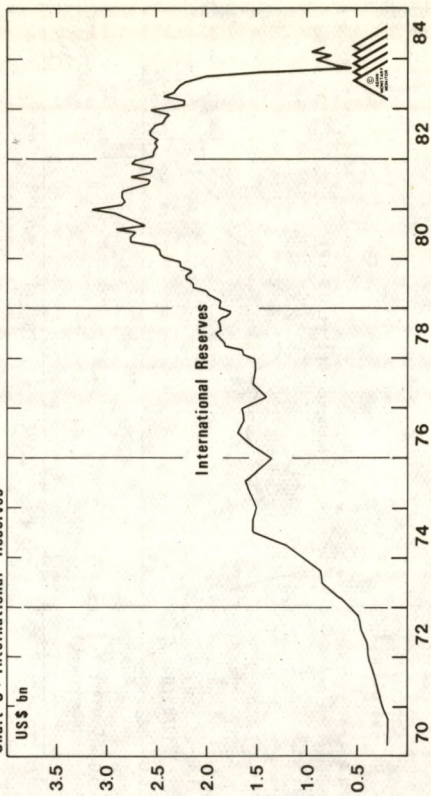


Chart C: International Reserves



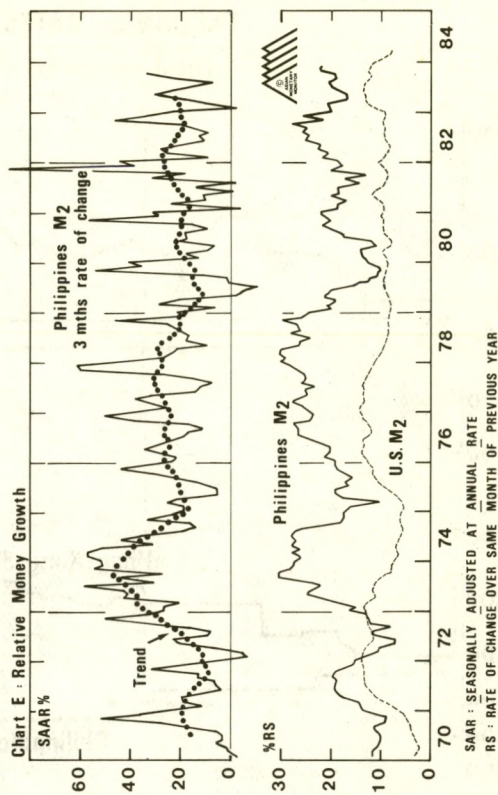
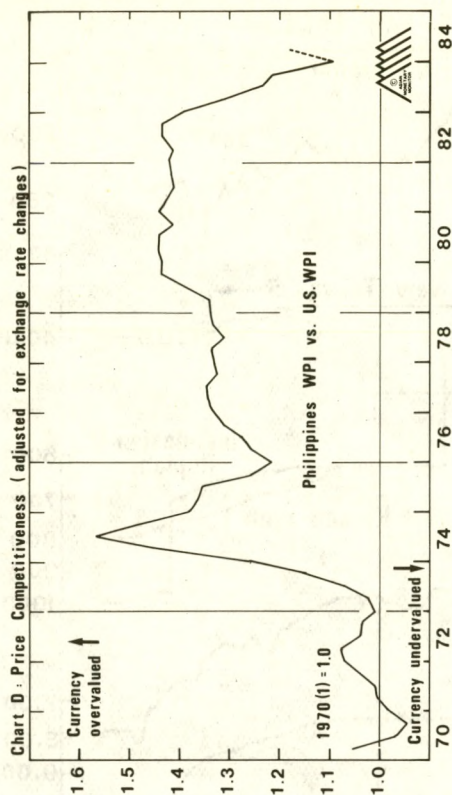
Since October of last year the Philippines has been in a state of severe economic crisis, triggered by the almost total depletion of the country's official foreign exchange reserves. Between end-August and end-October last year the Philippines' reported official reserves fell from US\$2.04 bn to only US\$400 m, although it is not clear how much of this fall was due to a loss of confidence by creditors following the August 21st assassination of Benigno Aquino, and how much was a Central Bank correction of previous reserve overstatements ahead of IMF negotiations. In January the previous head of the Central Bank, Jaime Laya, was replaced as a result of Central Bank overstatements of official reserves.

The lack of foreign reserves forced the Central Bank, in October, to instigate crisis measures in an effort to prevent the Philippines from defaulting on its debt obligations, the most important of which were a 21.4% devaluation of the peso (on October 5th), a moratorium on repayments of foreign debt, bans on non-essential imports, a requirement that commercial banks sell all foreign exchange receipts to the Central Bank, and a staggered increase in commercial banks' reserve requirements.

Successive increases in the commercial banks' required reserve ratio - which have taken the ratio from 18% in August to 24% now - were ordered in an attempt to prevent the debt crisis from developing into a hyper-inflation. This was an obvious potential problem as prior to the crisis the government's budget deficit had been effectively ultimately financed through either foreign borrowing or drawdowns of foreign reserves. With neither of these two options a possibility after October, the government's deficit had to be financed by increases in the monetary base.

Unfortunately, although the increases in reserve requirements have resulted in a severe squeeze on bank liquidity pushing interest rates sharply higher, they have not prevented a monetary and inflationary explosion. The (unadjusted) monetary base grew by 56.9% (non-annualised) in the last quarter alone as a result of monetisation of the budget deficit and a sharp rise in Central Bank credit to distressed financial institutions. This growth of the monetary base was accompanied by a 38% growth in M1 during the fourth quarter and has been followed by a surge in inflation which by February had risen to 37% year-on-year.

The Philippines is currently negotiating international borrowings totalling US\$3.3 bn, all of which are dependent upon an agreement being reached with the IMF. The IMF is insisting on a further large devaluation which must take effect soon, and hence the only question to be answered is how large will the devaluation be? As the estimate of purchasing power parity on Chart D indicates, the benefits of the October devaluation have already been wiped out by higher inflation. Hence the coming devaluation must be expected to be significantly larger than that one.

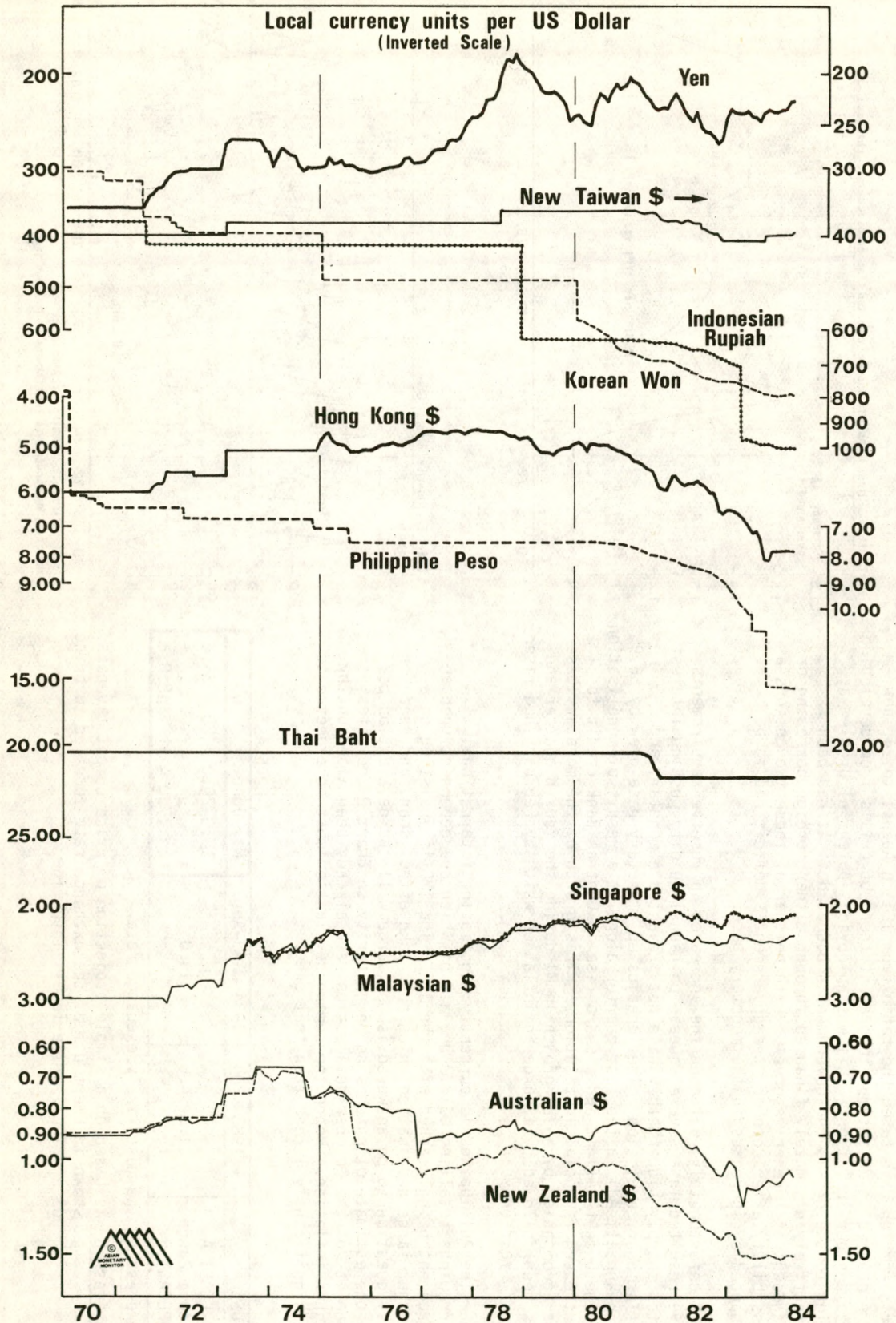


P/US\$	ACTUAL		FORECAST	
	1983	Q4 1984 Jan.-Apr.	May-June	Q3
FORECAST A			14.0-20.0	20.0-25.0
Actual Range	11.0-14.0	14.0		
FORECAST B			17.0	18.0

Forecast A The most likely exchange rate.

Forecast B is based on a simple projection of price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line.

EXCHANGE RATES IN THE FAR EAST

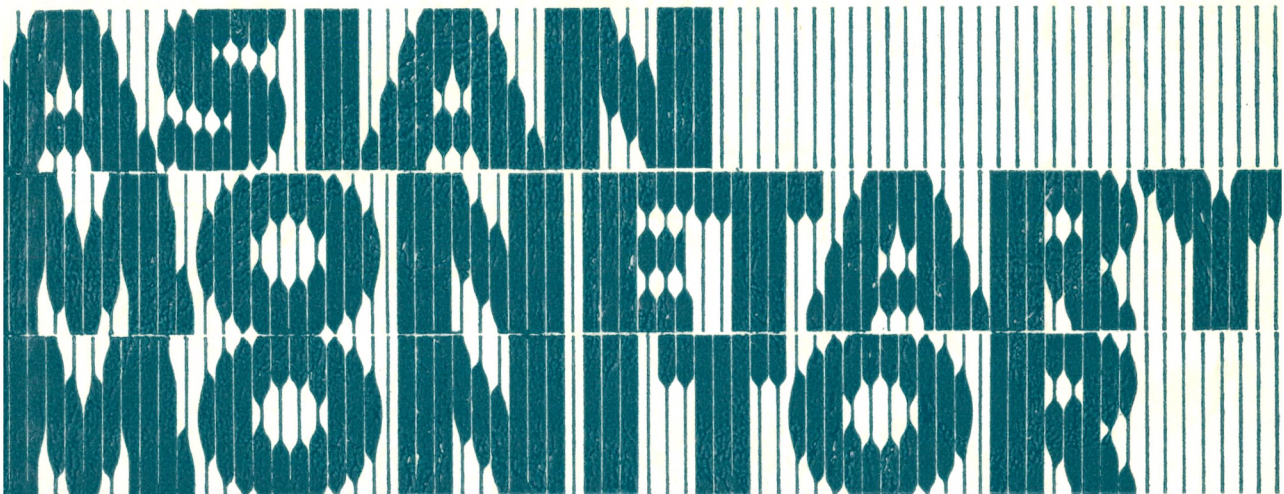






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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

REAL EFFECTIVE EXCHANGE RATES FOR 10 EAST ASIAN ECONOMIES

In future editions of Asian Monetary Monitor we will be including in the exchange rate forecasts for each country a chart of the real effective exchange rate. These charts will replace the current charts entitled 'Price Competitiveness (adjusted for exchange rate changes)'. As we have always placed a fair degree of emphasis on purchasing power parity in our exchange rate forecasts (often including a purchasing power parity estimate as an alternative 'forecast B' for the exchange rate) this note is intended to explain the rationale for this change in terms of the economic theory underlying the purchasing power parity theory of exchange rate determination, and the methodology of our calculation of the real effective exchange rate.

The real effective exchange rate for any one country is a weighted index of the exchange value of that country's currency in terms of the currencies of its major trading partners, adjusted for relative changes in price levels and weighted according to the volume of trade transacted with each trade partner. Hence the real effective exchange rate (REER) is simply a trade weighted index of price competitiveness adjusted for exchange rate changes, which extends the purchasing power parity concept from including only one currency (in our case the US dollar) to including the currencies of all the major trading partners of the country concerned. Each REER index has been set to a base of 100 so that a rise in the index above 100 signals that the country's currency is becoming overvalued relative to its trade weighted purchasing power parity estimate, and a fall below 100 indicates that it is becoming undervalued. Other things being equal a rise in the index can occur if the country's exchange rate vis-a-vis a major trading partner rises or if its inflation rate rises relative to a major trading partner, while the index will fall if the exchange rate or relative inflation rate falls.

Hence the basic rationale for including an estimate for the real effective exchange rate in a currency forecast is the same as for including a purchasing power parity estimate i.e. that over long periods of time one should expect a country's real effective exchange rate to tend back to 100, representing its purchasing power parity level. The simple theory behind this is that if the prices of goods in country A rise relative to the prices of goods in country B then the residents of country A will tend to purchase the relatively cheaper goods produced by country B. These purchases will represent a deterioration in country A's trade balance and will lower its exchange rate to the point where its international price competitiveness is restored.

The forces which operate to bring an exchange rate back to its purchasing power parity level thus depend, in theory, primarily on the influence of relative international competitiveness on trade flows. Trade flows can be distorted by barriers to the international movement of goods (e.g. transport costs, tariffs, quotas etc.) and this can lead to exchange rates deviating from purchasing power parity estimates. Much more importantly, prolonged divergences between exchange rates and purchasing power parity levels can occur as a result of international trade in financial assets and other investment flows. If an economy enjoys a persistent surplus on the capital account of its balance of payments, for instance, then that country's exchange rate might be expected to trade above the level suggested by the purchasing power parity theory. Although such divergences can indeed persist for long periods of time and be largely independent of business cycle influences, nevertheless empirical studies have shown that historically exchange rates have tended to fluctuate around purchasing power parity estimates over time.

The economic mechanisms which tend to align an exchange rate with its purchasing power parity estimate need not always involve an exchange rate movement only. This most obviously occurs when the Central Bank fixes the exchange rate. Then price levels in the economy will adjust to the exchange rate as Central Bank support for the currency peg impacts upon domestic money supply and acts to bring price levels into line with whatever is necessary to maintain a balance of payments equilibrium. Another way in which prices may appear to adjust to the exchange rate can occur when the currency is floating. Financial asset prices are generally more sensitive and respond more quickly to economic policy than goods prices. Hence, for instance, if the Central Bank of country A adopts a restrictive money policy then this might act to depress financial asset prices in the economy and draw in capital flows from country B. This will raise country A's exchange rate and make its currency appear temporarily overvalued when compared to relative goods prices in the two economies. The prices of goods in country A will fall with a lag as the effects of the restrictive monetary policy percolate through country A's economy.

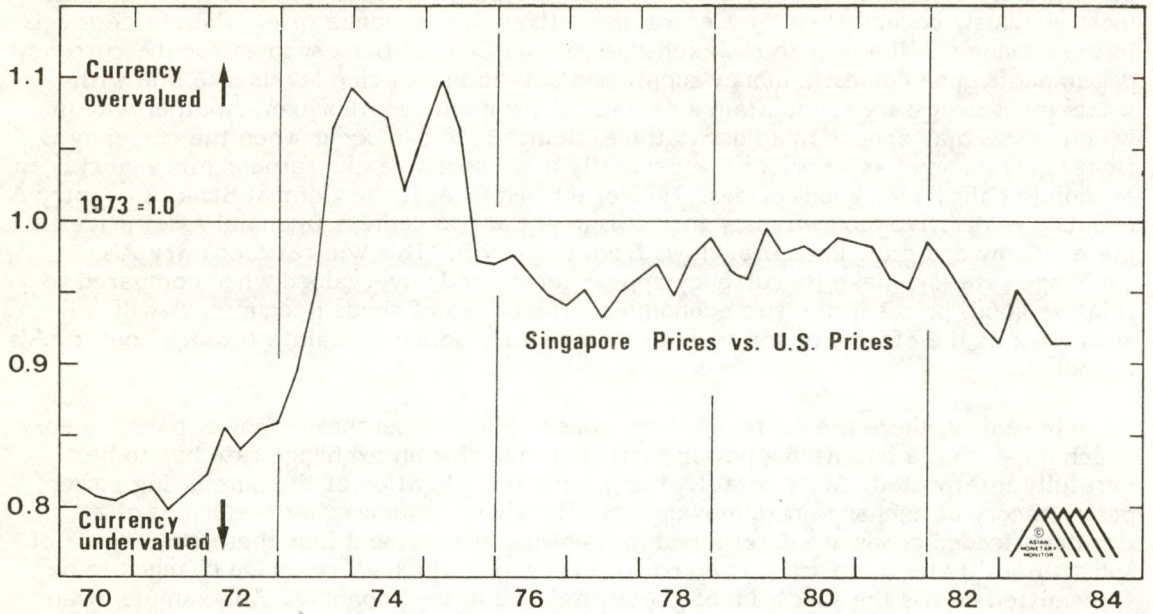
In reality, there are certain assumptions implicit in purchasing power parity theory which mean that a purchasing power parity estimate for an exchange rate has to be carefully interpreted. Most notably, the practical application of the purchasing power parity theory of exchange rate movements effectively assumes that the prices of a country's traded goods are determined in its own economy, and that there is a degree of substitutability between traded and non-traded goods which allows price changes to be transmitted across the spectrum of goods produced in the economy. An example of an economy which does not fulfil these assumptions is Malaysia. Roughly three quarters of Malaysia's exports are commodities, the prices of which are determined in world markets and which are consumed to only a limited extent in the domestic economy. In Malaysia's case the prices of domestically consumed goods have little implication for the prices of traded goods and a rise in traded goods prices (i.e. commodities) will not be a sign of decreased international competitiveness but a sign of increased world demand for Malaysia's output, which is more likely to be associated with a rise rather than a fall in the Ringgit exchange rate.

Nevertheless, despite inherent problems a purchasing power parity estimate for an exchange rate is a useful tool in currency forecasting as it does provide a benchmark which can determine when an exchange rate has become too far out of line with relative price trends. In this respect a real effective exchange rate is superior to a straight purchasing power parity estimate based on a single exchange rate, because the latter places equal emphasis on two economies whereas the real effective exchange rate emphasises economic factors in the country under consideration alone.

This is best seen by means of an illustration. Charts 1 and 2 indicate, respectively, the movement of the Singapore dollar exchange rate vis-a-vis the US dollar relative to its estimate of purchasing power parity against the US dollar, and the Singapore dollar's real effective exchange rate. Chart 1 appears to indicate that the Singapore dollar became increasingly undervalued between 1981 and 1983 whereas in past issues of AMM (see AMM Vol. 7 No. 5) we have suggested that the increasing overvaluation of the Singapore dollar contributed to Singapore's balance of payments deterioration in 1983. In fact, as Chart 2 shows, the Singapore dollar did become increasingly highly valued over the 1981-1983 period when measured against the currencies of Singapore's major trading partners, and Chart 1 really only indicates that the US dollar became generally overvalued during these years.

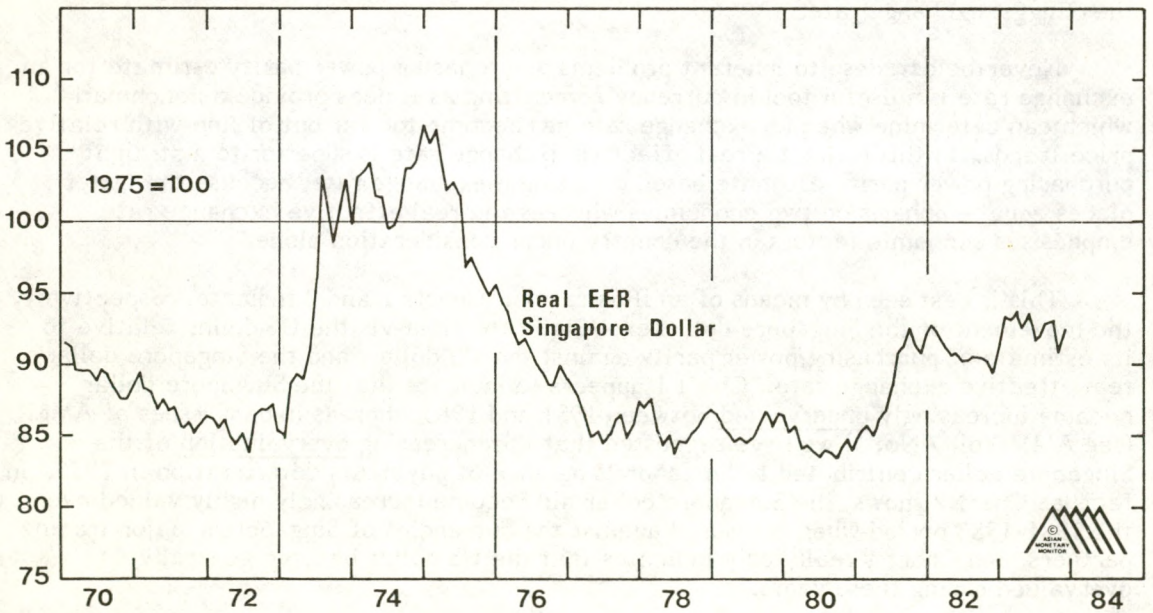
SINGAPORE

CHART 1 : SINGAPORE DOLLAR RELATIVE TO PURCHASING POWER PARITY ESTIMATE



SINGAPORE

CHART 2 : SINGAPORE DOLLAR , REAL EFFECTIVE EXCHANGE RATE



There are a number of practical problems to be tackled in the calculation of a country's real effective exchange rate. Given that the real effective exchange rate is a weighted index of exchange rates, the most obvious problem is how to weight the constituent component exchange rates. In our calculations we have chosen to consider only domestic exports, rather than total trade, in the calculation of weights. There are a number of reasons for choosing to do this, but the decision to use only domestic export weightings can be broadly justified on the grounds that the majority of the Asian Pacific Rim economies are either LDCs or NICs for which export competitiveness, rather than import substitution, is the economic driving force. For many of the East Asian economies a large proportion of imports still come under the 'essential' category. If imports were included in the weightings, a particular problem would be posed by oil imports as the cost of these imports is determined on world markets rather than by exchange rates and inflation rates in the Gulf states.

The major problem is deciding how to arrive at the appropriate export weighting to be allotted to the country's exchange rate vis-a-vis the currency of each major importer of the country's goods. The determinants of the volume of bilateral trade between two countries can be broken down into two major categories: price and non-price. For the first factor it is clear that if country A becomes more competitive than country B's other suppliers of a particular good, then country B may begin to import more of the good from A, thus making B a more important trade partner of country A. But B may also become a relatively larger importer of A's goods if, for instance, B advances to a higher stage of economic development and the composition of its imports changes or, alternatively, if political ties with country A improve. An example of this second type of 'non-price' determinant of trade flows might be the trade between Hong Kong and China. In 1978 PRC imports from Hong Kong were virtually insignificant but by 1983 China had become the fourth largest importer of Hong Kong produced goods.

Ideally, in this second case, one would want to capture the increased importance of country B as an importer of A's goods by increasing the weight attached to the rate of exchange between country B and country A's currency in the calculation of country A's real effective exchange rate. However, in the first case, the weight attached to the exchange rate of country B should not be increased as in this example the increased competitiveness of country A is a reflection of the fact that its exchange rate is becoming 'undervalued' compared to relative inflation rates in the two economies. This then, will be captured in the calculation of A's real effective exchange rate as a fall in the index below 100. Theoretically, any movement of country A's real effective exchange rate back to 100 as a result of an appreciation of A's exchange rate or rise in A's inflation rate should then reduce A's exports to B back to the level suggested by the weighting.

In practice it is not possible to isolate price from non-price determinants of trade flows and one is left with the choice of averaging exports over a number of years to arrive at trade weights for each country, or choosing one particular 'base year'. We have chosen the latter method in the belief that averaging will tend to incorporate changes in trade flows which result from changes in price competitiveness in the allotted weightings, and hence could undermine the value and accuracy of the real effective exchange rate calculation. We have therefore attempted to choose 'representative' years for base years for each country's real effective exchange rate. Nevertheless the method does have the drawback mentioned above and thus, for instance, the exchange rate for the remnimbi is not a constituent of our real effective exchange rate index for the Hong Kong dollar, even though the People's Republic of China is the fourth largest importer of Hong Kong goods. We have used the eight major importers of each country's goods at the base year, as set out in table 1, which also shows the base year and trade weightings which have been given to the exchange rates of each country.

TABLE 1

COMPONENTS AND WEIGHTINGS OF AMM REAL EFFECTIVE EXCHANGE RATES

	JAPAN	S.KOREA	TAIWAN	HONG KONG	N.ZEALAND
BASE YEAR	1970	1975	1970	1972	1976
<u>Component Exchange Rates</u>					
US Dollar	57.4%	39.4%	51.0%	51.4%	17.5%
Japanese Yen		33.1%	19.5%	4.0%	20.5%
German Mark	5.3%	8.0%	6.4%	12.8%	3.9%
UK Pound	4.6%	4.1%	-	18.4%	28.3%
Hong Kong Dollar	6.8%	4.7%	12.3%		-
Australian Dollar	5.7%	-	1.8%	3.7%	18.4%
Dutch Guilder	-	3.3%	-	2.5%	3.5%
Singapore Dollar	-	-	3.2%	2.9%	-
Canadian Dollar	5.4%	5.1%	4.6%	4.2%	3.8%
New Taiwan Dollar	6.8%	-		-	-
Korean Won	7.9%		-	-	-
French Franc	-	-	-	-	4.1%
Saudi Riyal	-	2.3%	-	-	-
Indonesian Rupiah	-	-	1.1%	-	-
	INDONESIA	MALAYSIA	THAILAND	PHILIPPINES	SINGAPORE
BASE YEAR	1971	1970	1972	1971	1975
<u>Component Exchange Rates</u>					
US Dollar	18.8%	19.2%	18.4%	44.0%	24.0%
Japanese Yen	54.9%	26.8%	30.2%	38.2%	18.7%
German Mark	5.6%	4.7%	3.6%	3.1%	7.3%
UK Pound	0.9%	9.7%	-	1.4%	6.8%
Hong Kong Dollar	-	-	10.9%	1.5%	15.3%
Australian Dollar	1.3%	3.3%	-	-	8.6%
Dutch Guilder	5.8%	4.7%	11.6%	7.4%	-
Singapore Dollar	12.0%	31.7%	12.7%	-	
Canadian Dollar	-	-	-	-	-
New Taiwan Dollar	-	-	5.4%	1.8%	-
Korean Won	-	-	-	2.7%	-
Malaysian Ringgit	-		7.3%	-	13.7%
Thai Baht	-	-		-	5.5%
Italian Lira	0.7%	-	-	-	-

Another very important consideration in the choice of the base year, and one which has to be addressed in any method of purchasing power parity estimation, is the question of starting conditions. As the exchange rate at the base year chosen represents the benchmark against which the degree of a currency's over- or under-valuation is to be measured, then the balance of payments in that year must be seen to be in rough 'equilibrium'. In practice, this is very difficult to ascertain and the real effective exchange rate ruling at any one time is best compared to that ruling in a number of years and not just the '100' level ruling in the base year.

Bearing in mind the above caveats, the complete formula for the calculation of a country's real effective exchange rate is set out below:

$$REER(A)_T = 100 * \sum_{I=1}^8 \frac{ER(I/A)_T * CPI(A)_T}{CPI(I)_T} * \frac{CPI(I)_B * W_I}{CPI(A)_B * ER(I/A)_B}$$

In this formula 'ER' is an abbreviation for 'exchange rate', 'CPI' for consumer price index, subscript B represents the base period and T the current period, A represents the country under consideration and I each of its eight major trading partners, with W_I representing the export weight allotted to each partner's exchange rate. The first part of the formula is the important part, representing as it does those components of the calculation which determine changes in a real effective exchange rate from one period to the next, namely the consumer price index of the country concerned, its exchange rates vis-a-vis its trading partners and the consumer price indices of those trading partners in any one period. The second part of the formula merely represents an adjustment which indexes all the exchange rates and consumer price indices to the same value at the base period. It can easily be seen that at the base period, i.e. when $T=B$, the right hand side of the equation reduces to

$$100 * \sum_{I=1}^8 W_I$$

As the sum of the W_I necessarily equals one this simply tells us that the real effective exchange rate is indexed to 100 at the base year which is necessarily true and explains the need for the adjustment factor in the equation.

Charts and tables for the real effective exchange rates of ten Asian Pacific Rim economies are included on the next six pages. These charts, along with the chart for Australia, will be included in future editions of AMM as an additional input to our exchange rate forecasts.

TABLE 2

REAL EFFECTIVE EXCHANGE RATES FOR 10 EAST ASIAN ECONOMIES 1970 - 1983 *

		JAPAN YEN	S.KOREA WON	TAIWAN DOLLAR	HONG KONG DOLLAR	N.ZEALAND DOLLAR
BASE YEAR		1970	1975	1970	1972	1976
1970	1	100.7	134.4	97.7	96.7	108.5
	2	99.8	133.8	99.3	96.4	108.4
	3	98.3	132.5	102.8	99.0	108.8
	4	100.9	133.6	99.9	97.3	111.0
1971	1	100.6	136.7	98.7	96.4	113.0
	2	101.3	133.3	97.2	94.2	113.0
	3	105.7	119.3	92.0	97.3	113.6
	4	113.3	115.8	83.9	95.6	113.7
1972	1	117.7	113.2	85.9	98.7	113.0
	2	119.1	111.4	93.1	99.2	112.8
	3	119.8	111.9	97.9	100.7	113.7
	4	121.2	108.9	89.5	100.9	114.1
1973	1	130.6	101.5	93.8	108.8	115.4
	2	138.6	96.2	95.9	113.1	114.7
	3	138.7	94.2	98.0	121.8	119.8
	4	134.5	96.7	104.1	118.7	126.8
1974	1	134.9	104.2	120.3	123.3	124.6
	2	138.0	109.8	129.6	120.0	122.7
	3	131.6	109.5	131.6	120.5	121.2
	4	133.8	103.0	130.6	121.0	114.7
1975	1	137.8	91.7	126.3	117.6	114.1
	2	138.7	98.2	126.3	111.8	113.7
	3	136.0	104.3	127.9	110.7	103.2
	4	135.7	105.8	125.8	111.4	98.1
1976	1	138.1	105.8	124.2	111.4	99.7
	2	141.7	107.4	123.7	114.6	100.1
	3	144.7	106.8	121.2	116.1	101.5
	4	145.6	107.2	119.0	118.3	98.6

* Based on consumer price data for each country.

Quarterly Averages of Monthly Data

		JAPAN YEN	S.KOREA WON	TAIWAN DOLLAR	HONG KONG DOLLAR	N.ZEALAND DOLLAR
BASE YEAR	1970		1975	1970	1972	1976
1977	1	151.8	106.9	118.7	120.7	99.1
	2	157.1	106.4	118.9	117.2	100.8
	3	159.6	107.6	122.9	117.3	102.6
	4	172.9	104.2	117.4	113.4	103.7
1978	1	178.6	106.1	115.8	113.7	104.2
	2	192.5	105.3	114.9	112.5	104.0
	3	214.9	104.2	118.2	109.7	103.8
	4	210.7	104.7	119.4	105.9	104.6
1979	1	190.4	109.6	119.2	105.4	105.5
	2	174.8	117.2	121.8	101.4	105.7
	3	170.2	117.0	123.4	101.3	103.3
	4	153.4	121.2	123.7	103.3	103.7
1980	1	148.6	110.8	127.2	105.7	103.7
	2	160.8	108.1	126.4	103.8	101.7
	3	164.6	106.8	130.7	104.3	101.9
	4	169.6	105.6	135.1	102.2	101.8
1981	1	169.1	108.4	137.3	103.1	101.7
	2	159.6	112.8	139.9	104.1	101.8
	3	148.9	119.3	140.0	99.6	102.5
	4	155.5	113.0	132.6	101.8	101.0
1982	1	145.8	113.9	135.1	103.3	102.3
	2	142.0	112.7	132.2	105.3	103.9
	3	132.6	114.5	131.5	103.2	106.3
	4	138.2	112.8	126.5	96.1	107.6
1983	1	147.6	110.8	124.4	99.6	105.3
	2	148.0	108.6	125.8	95.0	100.3
	3	146.0	107.9	126.5	90.0	101.0
	4	152.0	102.0	125.4	91.4	100.7

TABLE 2 Continued

REAL EFFECTIVE EXCHANGE RATES FOR 10 EAST ASIAN ECONOMIES 1970 - 1983*

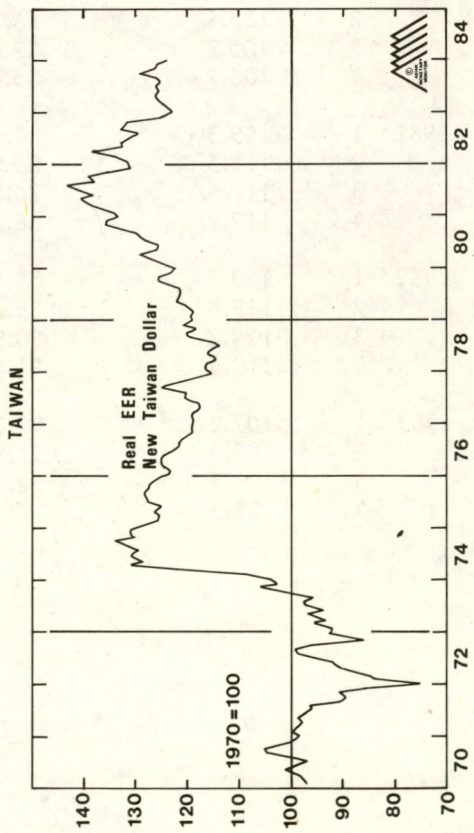
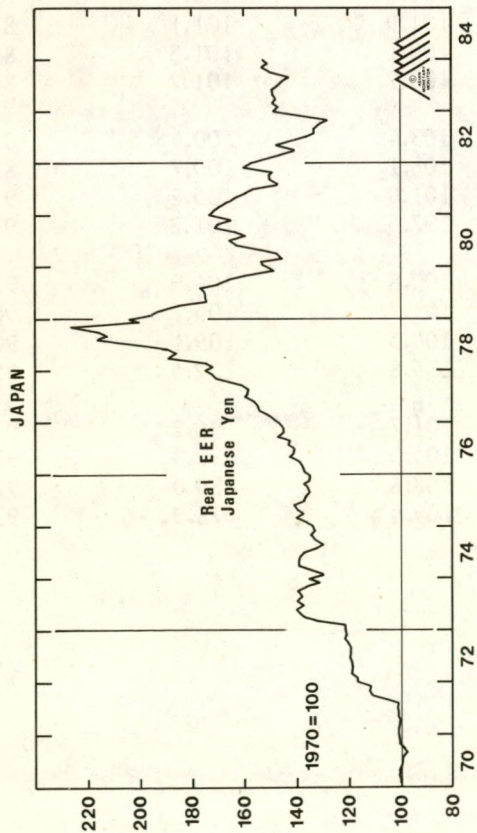
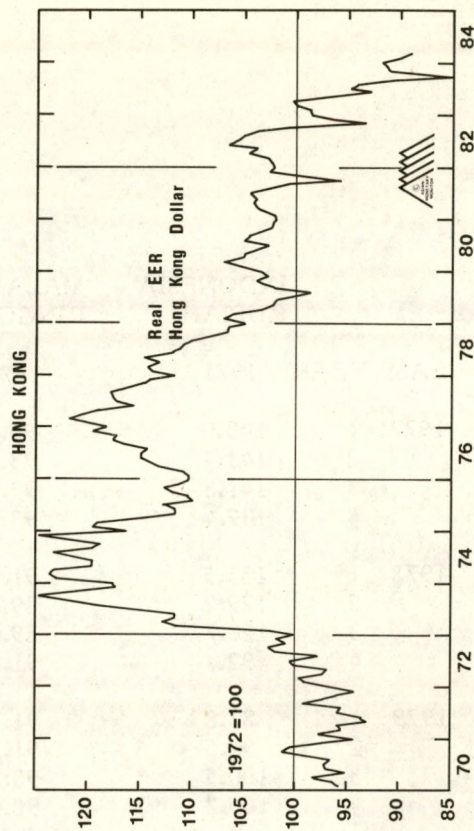
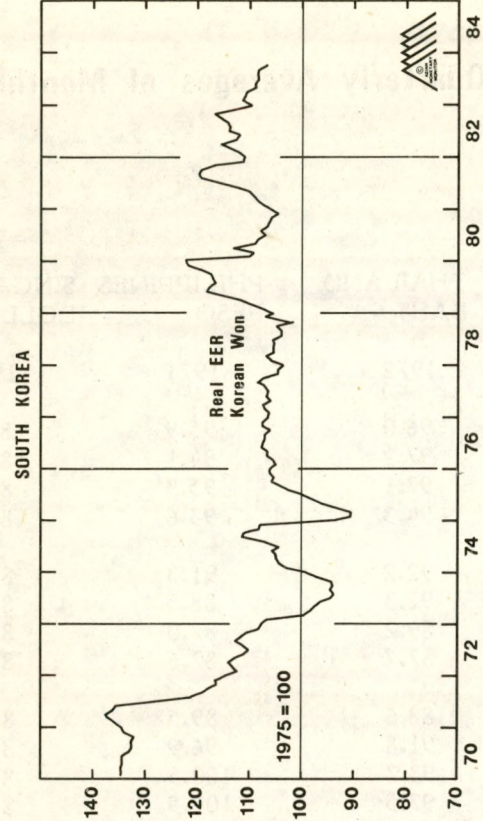
		INDONESIA RUPIAH	MALAYSIA RINGGIT	THAILAND BAHT	PHILIPPINES PESO	SINGAPORE DOLLAR
BASE YEAR		1971	1970	1972	1971	1975
1970	1	127.7	101.4	117.1	112.7	90.8
	2	107.5	99.9	115.4	96.0	89.3
	3	107.3	99.7	114.0	97.2	89.1
	4	105.7	99.0	111.8	96.7	87.9
1971	1	111.2	99.3	110.2	99.0	88.7
	2	106.8	97.1	109.2	98.3	87.0
	3	94.1	95.7	107.1	102.1	86.2
	4	88.7	95.9	104.0	100.8	85.8
1972	1	87.9	96.4	99.8	99.9	86.0
	2	85.8	96.4	99.4	93.2	84.8
	3	83.5	97.3	99.4	97.7	85.7
	4	94.9	96.9	101.7	93.6	86.5
1973	1	93.0	97.8	97.2	88.5	87.6
	2	90.3	99.3	93.5	88.1	92.1
	3	94.4	104.5	93.3	93.0	100.8
	4	101.8	104.6	98.4	98.9	101.2
1974	1	114.4	104.4	102.3	105.0	103.7
	2	115.5	103.9	104.0	107.0	101.1
	3	118.6	104.6	105.6	114.6	101.5
	4	120.6	105.0	102.4	108.8	104.9
1975	1	120.7	105.9	98.2	105.2	105.5
	2	123.7	102.8	99.2	103.0	102.3
	3	129.5	96.3	102.4	97.6	96.8
	4	135.8	94.1	102.4	96.5	95.4
1976	1	141.2	94.8	102.2	97.4	93.5
	2	142.6	95.2	100.7	97.9	91.3
	3	145.4	96.6	98.6	97.7	89.2
	4	146.1	95.3	98.7	96.0	89.1

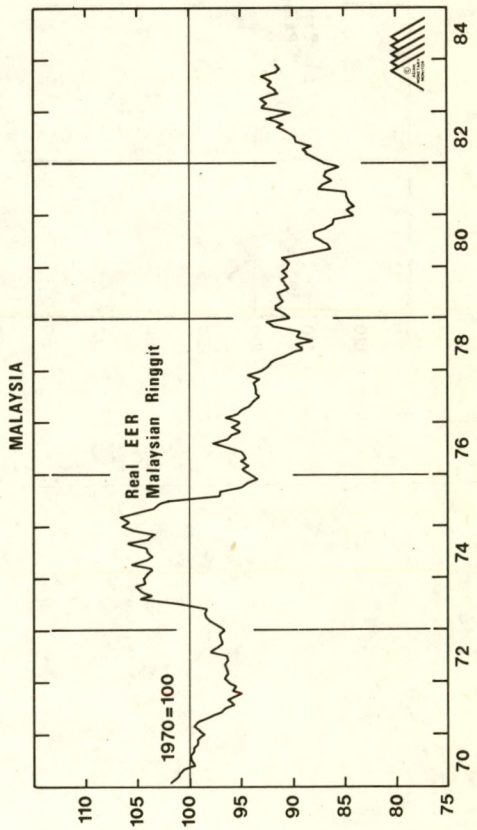
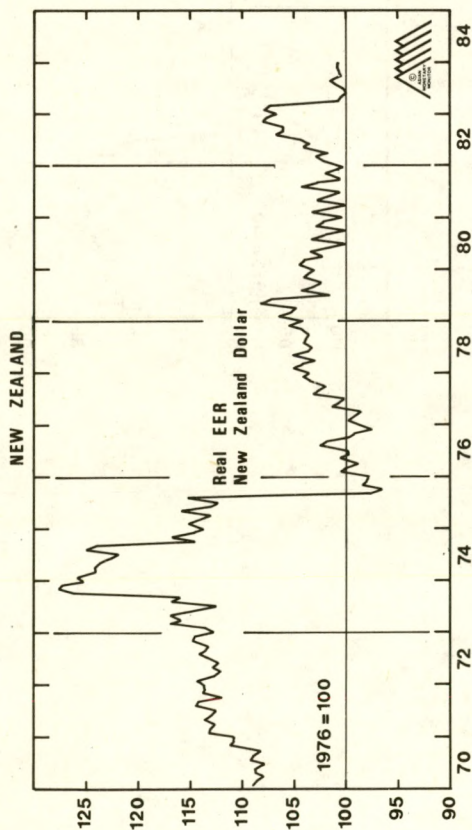
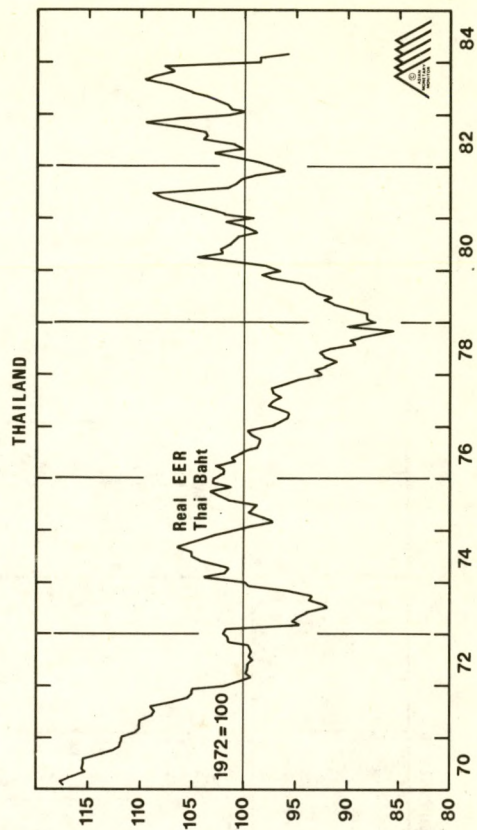
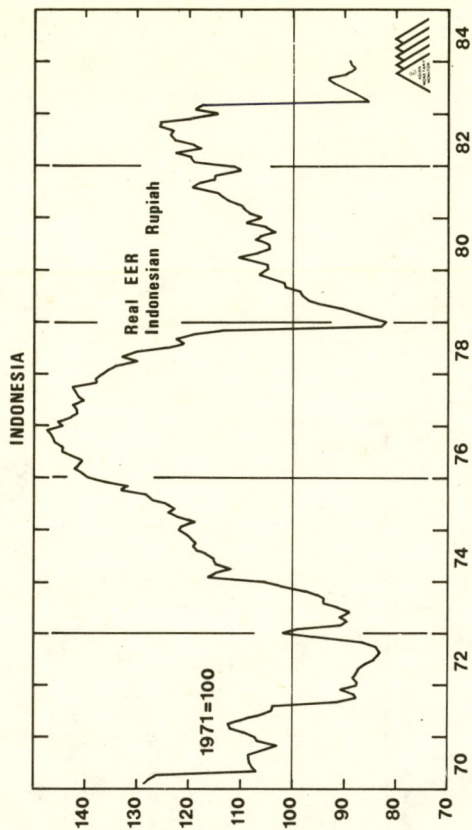
* Based on consumer price data for each country.

Quarterly Averages of Monthly Data

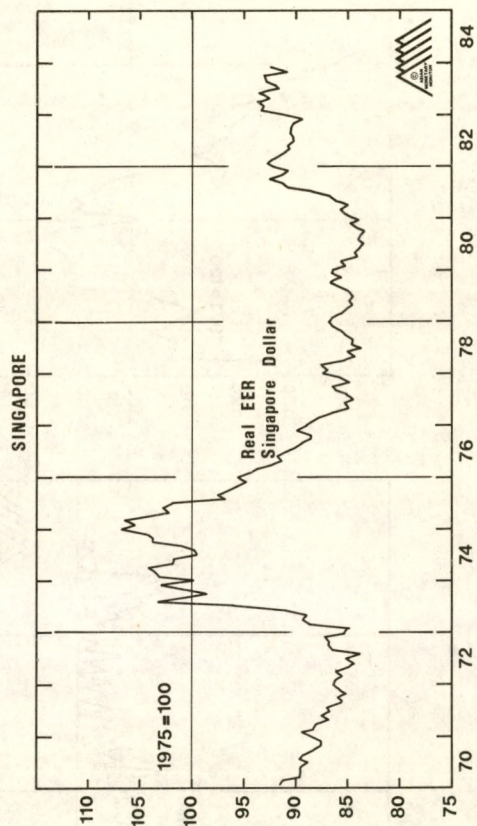
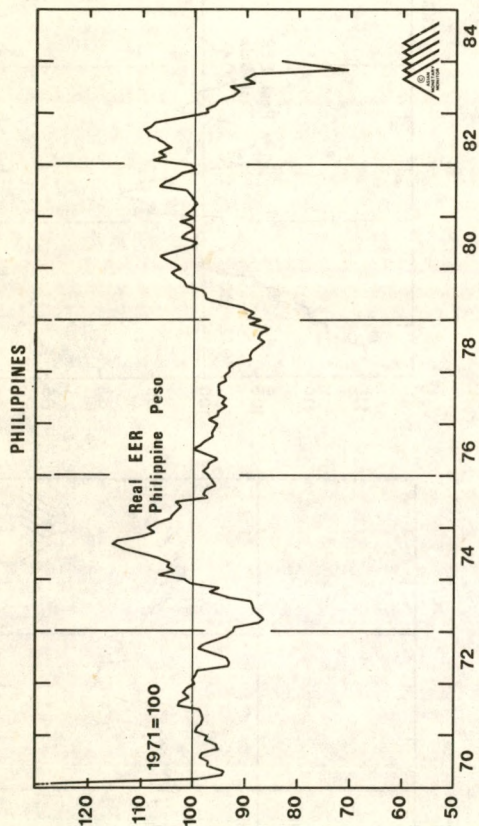
		INDONESIA RUPIAH	MALAYSIA RINGGIT	THAILAND BAHT	PHILIPPINES PESO	SINGAPORE DOLLAR
BASE YEAR		1971	1970	1972	1971	1975
1977	1	143.0	95.6	96.0	95.9	87.6
	2	141.3	93.7	97.2	94.1	84.9
	3	141.8	93.7	97.1	95.3	86.0
	4	137.4	93.5	94.3	93.6	86.0
1978	1	133.5	91.8	92.2	91.3	86.7
	2	129.2	89.6	92.3	88.5	84.3
	3	120.7	89.0	89.2	87.0	84.8
	4	92.7	91.6	87.7	87.6	86.4
1979	1	87.8	91.3	88.6	89.5	85.7
	2	96.5	91.2	91.8	96.9	84.7
	3	100.5	90.8	93.7	100.5	85.8
	4	105.2	90.6	97.5	103.5	86.3
1980	1	107.7	90.0	101.2	104.9	85.1
	2	105.1	86.7	101.9	101.1	83.8
	3	105.7	87.6	100.1	101.3	83.8
	4	106.7	85.4	100.2	101.2	84.3
1981	1	109.3	84.5	103.4	100.4	85.3
	2	113.5	85.8	108.1	100.7	87.2
	3	117.6	86.8	101.0	105.2	91.6
	4	112.1	86.5	97.5	101.2	91.4
1982	1	120.5	88.4	100.8	106.9	92.1
	2	119.8	89.3	101.7	105.7	90.6
	3	124.2	90.9	104.5	109.1	90.4
	4	119.9	91.4	105.8	102.5	90.3
1983	1	107.2	92.8	101.7	96.2	93.5
	2	88.5	91.9	105.0	92.3	92.6
	3	91.3	92.2	108.6	89.0	92.7
	4	88.5		104.4	76.9	92.1

REAL EFFECTIVE EXCHANGE RATES FOR 10 EAST ASIAN ECONOMIES





REAL EFFECTIVE EXCHANGE RATES FOR 10 EAST ASIAN ECONOMIES Continued



AUSTRALIA

A CHANGE IN DOMESTIC INTEREST RATE TRENDS

Australian interest rates have declined quite sharply over the last two years. The cyclical peak in both long and short dated Australian interest occurred during the second quarter of 1982. Three month Treasury Bills yielded more than 19% in May of that year, whilst the yield on ten year Federal Government securities had risen to a high of approximately 16 1/2%. Since then, Australian interest rates have fallen in an irregular and volatile manner with, for example, three month Treasury Bill yields declining to 8 1/2% in December 1983, their lowest level since early 1979.

The Fundamental Macro-Economic Influences Underlying Declining Interest Rates During 1982 and 1983

There were essentially two fundamental developments underlying the cyclical decline in Australian interest rates during the second half of 1982 and during 1983. First, the domestic economy weakened throughout 1982 and the recession brought about reduced private sector credit demands and a cyclical decline in inflation. Second, Australia enjoyed a substantial surplus on its overall balance of payments during 1982 and 1983. This external surplus occurred at a time when the Reserve Bank was implementing a managed exchange rate policy which implied that the central bank was persistently intervening in the foreign exchange market to sell Australian dollars. As a result of the external surplus, therefore, the Reserve Bank's foreign exchange market transactions effectively eased local money market conditions, encouraging downward pressure on domestic short interest rates.

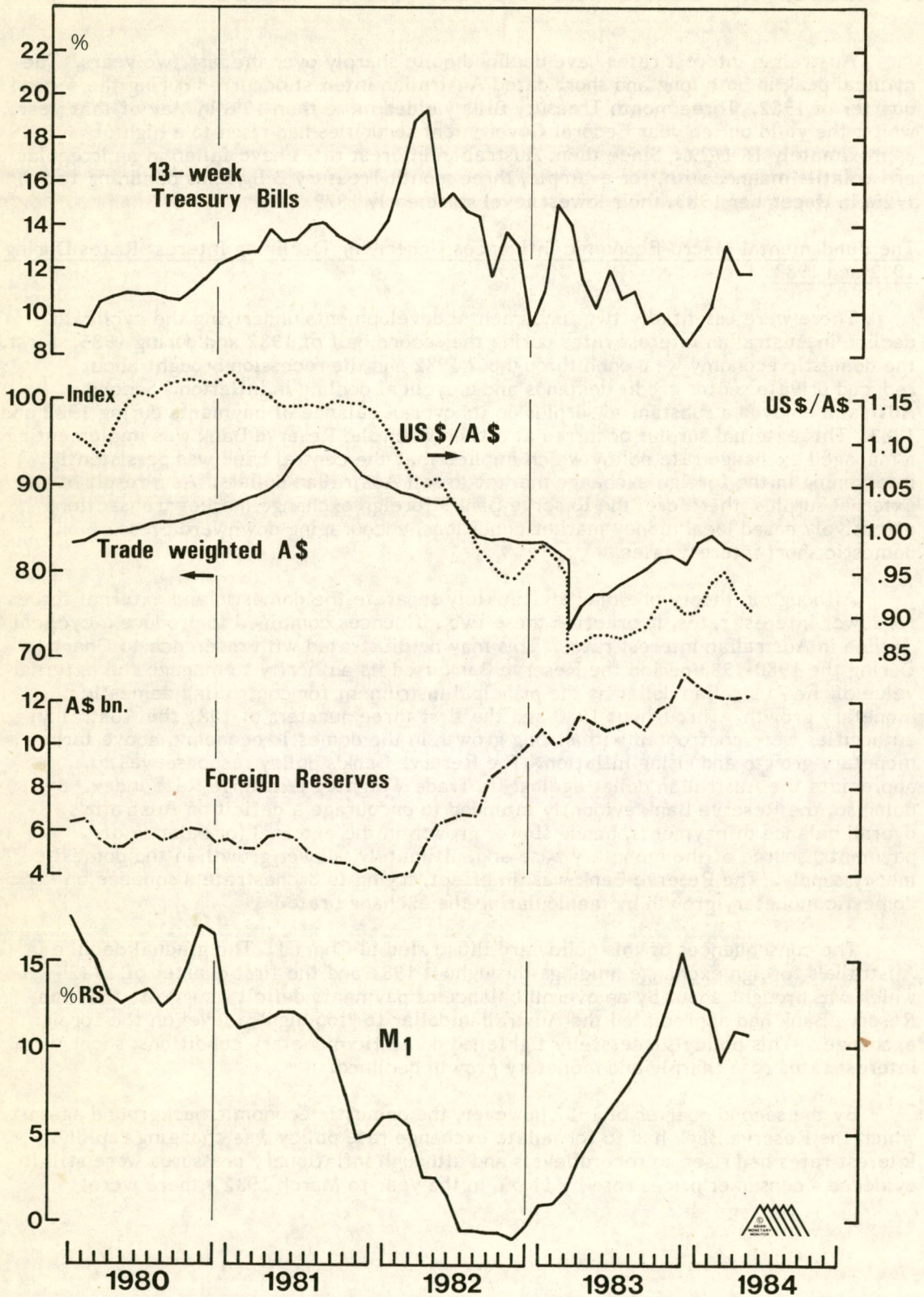
Although in theory one may legitimately separate the domestic and external forces for lower interest rates, in practice these two influences combined to produce a cyclical decline in Australian interest rates. This may be illustrated with reference to Chart 1. During the 1980-1983 period the Reserve Bank used its authority to manage the external value of the Australian dollar as the principal instrument for controlling domestic monetary growth. Throughout 1980 and the first three quarters of 1981 the Australian authorities were confronted with strong growth in the domestic economy, above target monetary growth and rising inflation. The Reserve Bank's policy response was to appreciate the Australian dollar against its Trade Weighted Exchange Rate Index. By doing so, the Reserve Bank evidently intended to encourage a deficit on Australia's overall balance of payments, hence slower growth in the external (or balance of payments) source of the monetary base and, ultimately, slower growth in the domestic money supply. The Reserve Bank was, in effect, trying to orchestrate a squeeze on domestic monetary growth by manipulating the exchange rate.

The consequences of this policy are illustrated in Chart 1. The gradual decline in Australia's foreign exchange holdings throughout 1981 and the first quarter of 1982 - which was brought about by an overall balance of payments deficit - suggests that the Reserve Bank had appreciated the Australian dollar to "too high" a level on the foreign exchanges. This policy successfully tightened domestic monetary conditions; short term interest rates rose sharply and monetary growth declined.

By the second quarter of 1982 however, the domestic economic background against which the Reserve Bank had to formulate exchange rate policy was changing rapidly. Interest rates had risen to record levels and although inflationary pressures were still in evidence - consumer prices rose by 11.5% in the year to March 1982 - there were

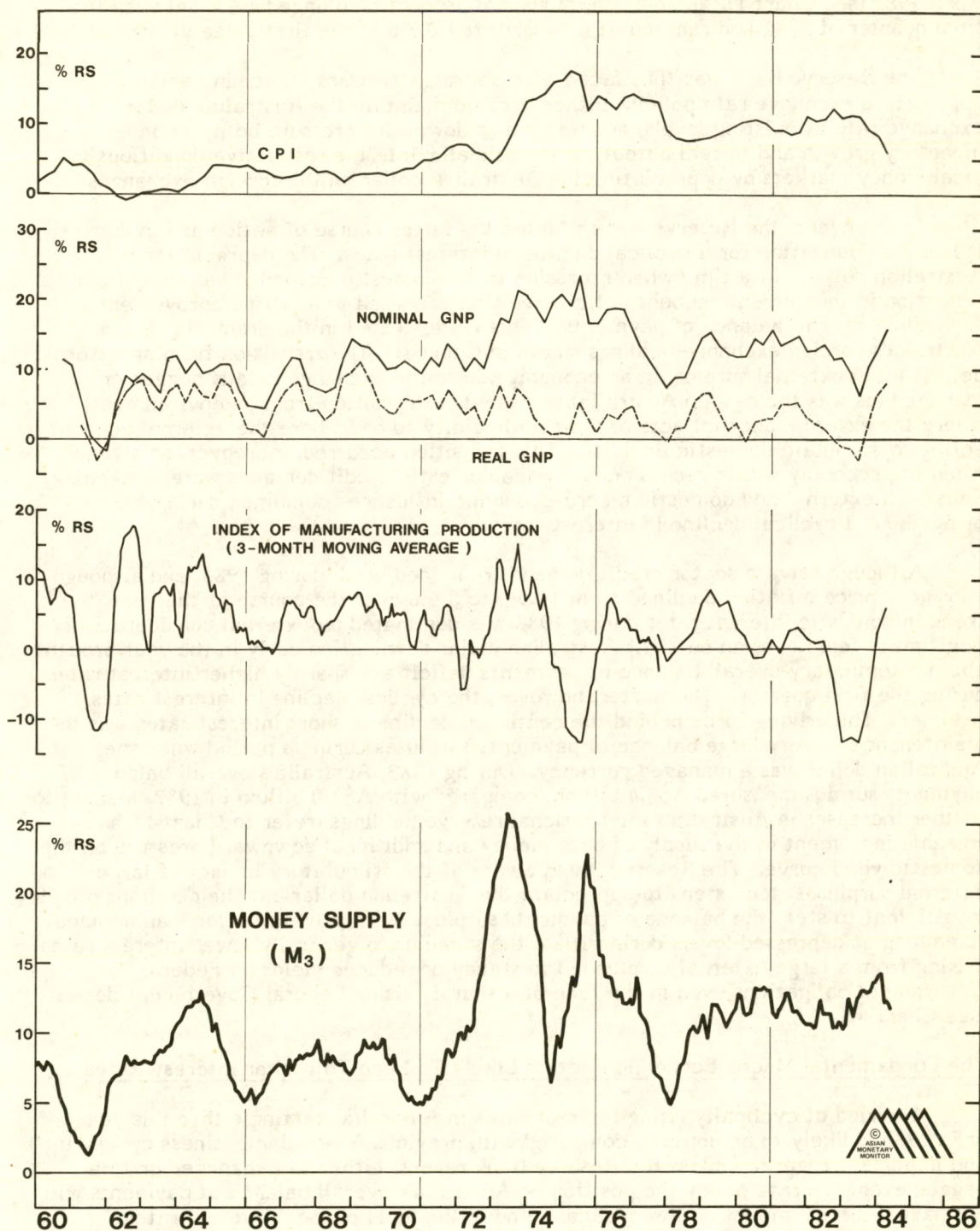
Australia : Chart 1

M₁, Foreign Reserves, Exchange Rate and 13 week Treasury Bill Yields



AUSTRALIA

CHART 2: MONEY, OUTPUT, AND PRICES



* Change of data series.



increasing signs that monetary growth had been subdued and that the real economy was weakening. M3 growth had apparently stabilised at close to the 10%-12% target level whilst M1 growth had plunged from 15.5% in December 1980 to 2.4% (year-to-year) in April 1982 (see Chart 1). In addition, industrial production plunged 4.6% between the final quarter of 1981 and real (non-farm) GNP fell 0.7% in the first three months of 1982.

The Reserve Bank was thus faced with a straightforward choice in deciding upon an appropriate exchange rate policy. Either it could maintain the Australian dollar exchange rate at existing levels, adding further downward pressure both to domestic monetary growth and to real output, or it could alleviate the restrictive conditions in local money markets by depreciating the Australian dollar on the foreign exchanges.

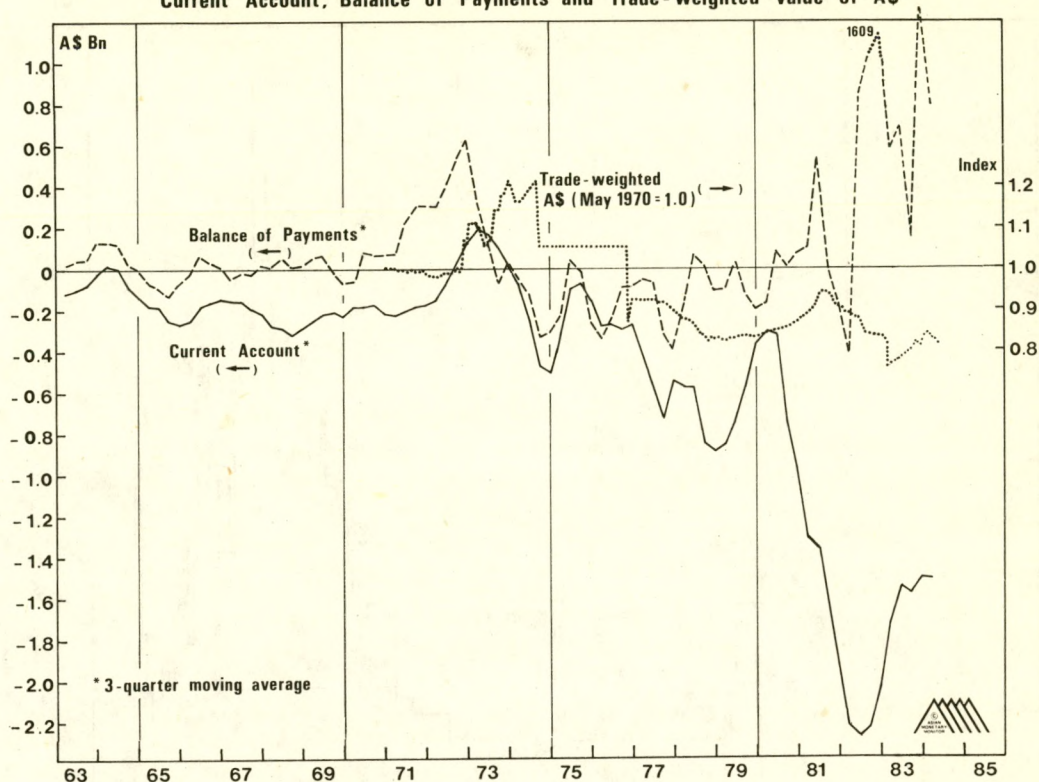
In the event, the Reserve Bank adopted the latter course of action and in doing so it laid the foundation for a cyclical decline in interest rates. The depreciation of the Australian dollar - at a time when recession in the domestic economy was encouraging a reduction in the current account deficit (see Chart 3) - led to a swift improvement in Australia's overall balance of payments. (This is illustrated in the dramatic rise in Australia's foreign exchange holdings shown in Chart 1.) The transition from an external deficit to an external surplus, in an economy where the exchange rate is pegged or managed (as was the case in Australia) represents a transition from an environment where the external account acts to restrain liquidity to one where the external account is acting to stimulate domestic liquidity. This transition occurred, moreover, at a time when the economy was in recession and when domestic credit demands were weakening. Thus both external and domestic macro-economic influences combined during 1982 to bring about a cyclical decline in interest rates.

Although private sector credit demands remained weak during 1983, and although consumer price inflation declined from 11.5% to 8.6% over the course of the year, the trend in domestic interest rates during 1983 was dominated by external considerations. Legitimate fears over an outright Australian dollar devaluation early in the year brought about a temporary overall balance of payments deficit and sharply higher interest rates during the first quarter. Thereafter, however, the cyclical decline in interest rates resumed. The driving force behind the continued decline in short interest rates was the maintenance of very large balance of payments surpluses during a period when the Australian dollar was a managed currency. During 1983, Australia's overall balance of payments surplus measured A\$3.4 billion, compared with A\$3.0 billion in 1982, leading to further increases in Australia's international reserve holdings (refer to Chart 1), a sizeable increment in the supply of base money and additional downward pressure on the domestic yield curve. The Reserve Bank, aware of the stimulatory impact of large external surpluses, took steps to appreciate the Australian dollar but their actions proved insufficient to stem the balance of payments surplus. With private sector loan demand remaining at depressed levels during 1983, the stimulus to generally lower interest rates arising from a large external surplus led to steady or reduced yields on Federal Government obligations even in the face of a sharply rising Federal Government deficit (see Chart 4).

The Fundamental Macro-Economic Factors Likely To Lead To Higher Interest Rates

A period of cyclically rising interest rates in Australia starting either this year or in 1985 is likely to be unusual, compared with previous Australian business cycles, in one important regard. Unless the Reserve Bank reverts either to a managed or to a pegged exchange rate policy the position on Australia's overall balance of payments will not have a direct impact on the cyclical trend in the level of local interest rates.

AUSTRALIA
Chart 3
Current Account, Balance of Payments and Trade-weighted Value of A\$



AUSTRALIA

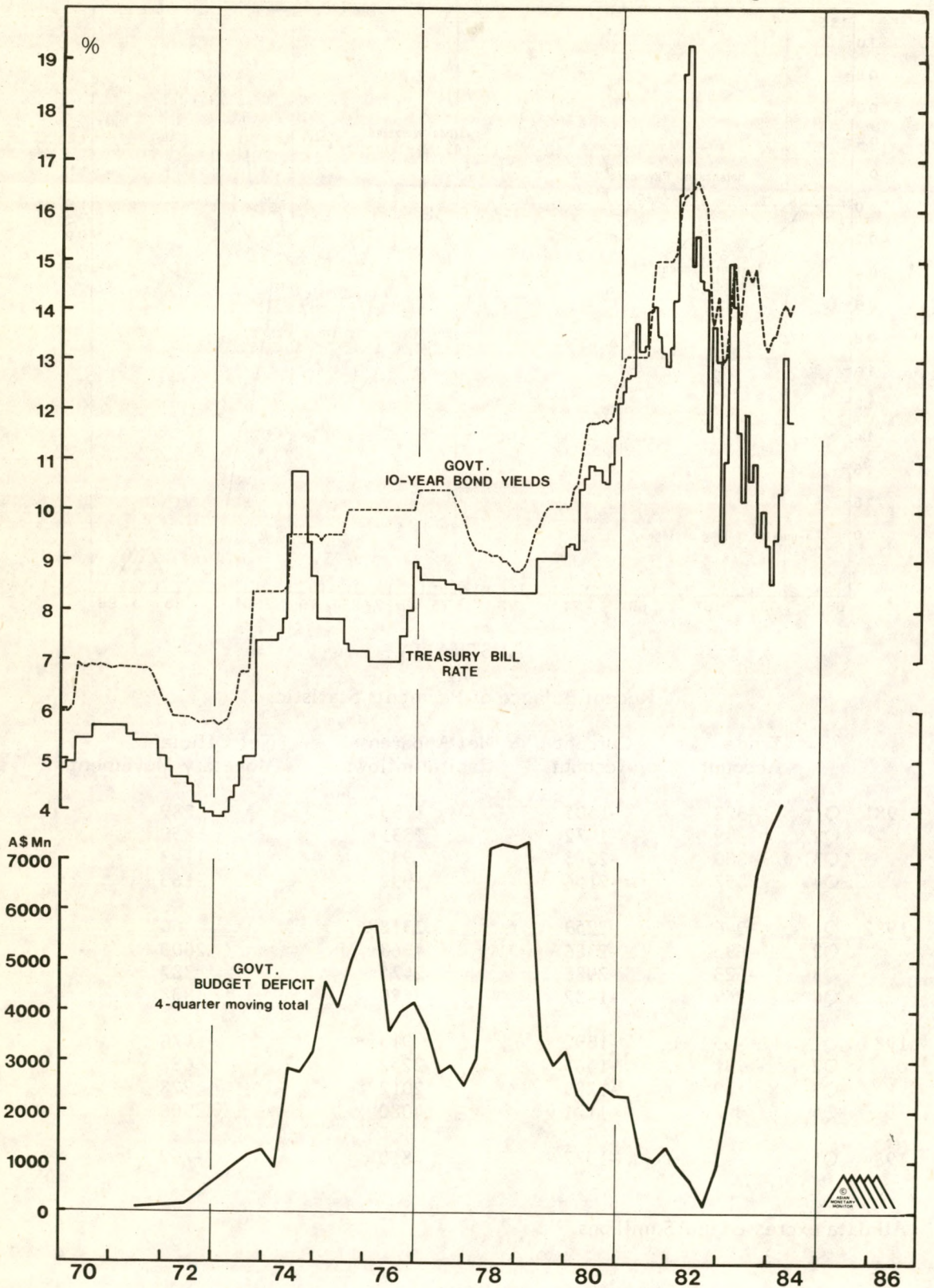
Recent Balance of Payments Statistics

		Trade Account	Current Account	Net Apparent Capital Inflows	Net Official Monetary Movements
1981	Q1	-328	-1505	1795	289
	Q2	-39	-1472	2331	859
	Q3	-800	-2073	930	-1143
	Q4	-857	-2156	1992	-163
1982	Q1	-946	-2259	2318	60
	Q2	-695	-2386	4968	2600
	Q3	-623	-2088	2475	387
	Q4	-269	-1682	3520	1838
1983	Q1	-55	-1392	915	-476
	Q2	31	-1565	2252	687
	Q3	-119	-1789	2012	228
	Q4	367	-1171	4080	2906
1984	Q1	3	-1577	810	-762

All data expressed in A\$ millions.

AUSTRALIA : CHART 4

Interest Rates and the Commonwealth Government Budget Deficit



When the Reserve Bank abandoned its managed exchange rate policy in December 1983 it effectively assumed direct responsibility for domestic monetary policy. Thus the cyclical trend in Australian monetary growth and, over time, Australian interest rates will be determined mainly by the direct actions of the Reserve Bank. The potential importance of this change in basic macro-economic policy is perhaps best underlined by noting that in the first five months of this year Australia's overall balance of payments, as measured by net official monetary movements, recorded a deficit of A\$933 million. In the presence of a pegged or managed exchange rate the transition from an external surplus of A\$2.9 billion in the fourth quarter of 1983 to the moderately large deficits recorded so far this year would almost certainly have induced strong upward pressure on local interest rates. In fact, local Treasury Bill yields are now only moderately higher than in October 1983 and the brunt of the deterioration in Australia's external account appears to have been borne by the exchange rate which has depreciated by some 5% against the Trade Weighted Exchange Rate Index from its February high.

The macro-economic influences which are likely to sustain a rising trend in Australian interest rates over the next year or two arise mainly from developments in the domestic economy. It is probable, in particular, that monetary growth in Australia over the last eighteen months has been too high to sustain the lower rates of inflation witnessed during the past year. In addition, the Reserve Bank's effectively accommodative monetary policy is likely to ensure a continuation of the strong recovery in domestic economic activity. This, eventually, will lead to a revival of private sector credit demands at a time when public sector claims on the supply of credit are likely to remain strong. The probability of higher inflation in Australia, the likelihood of rising private sector credit demands and the need, ultimately, for the Reserve Bank to restrain monetary growth are each likely to lead to a rising trend in domestic interest rates.

Chart 5 highlights the influence of an accommodative monetary policy in encouraging a strong recovery in Australian real GNP. Chart 5 indicates that the combination of rapid growth in M3 - which rose above target throughout most of 1983 - at a time when inflation has been declining rapidly* has led to comparatively rapid growth in real M3. Real monetary growth may be thought of as a proxy for generalised real purchasing power in the domestic economy and the recent cyclical increase in real M3 has been a substantial catalyst to a strong recovery in Australia. The strength of recovery in this business cycle is, in terms of the simple model depicted in Chart 5, only sustainable if domestic inflation can be maintained at close to current levels. Yet the evidence from Chart 6 suggests that current levels of M3 growth may be too high to prevent a cyclical upturn in inflation. Indeed, notwithstanding the continuation of the Prices and Incomes Accord, the latest GDP deflator data tends to suggest that a flattening and then subsequent cyclical rise in domestic inflation may not be postponed for long. A cyclical rise in inflation would, eventually, provide the basis for a rising trend in longer dated interest rates and to forestall this it is likely that the Reserve Bank will raise the level of short term interest rates as a means of tightening domestic monetary policy.

* The decline in consumer price inflation from 11.7% in December 1982 to 5.9% in March 1984 is overstated somewhat by changes in the statistical treatment of health costs in the first quarter of this year. The GDP deflator declined from 10.4% to 6.8% over the same period.

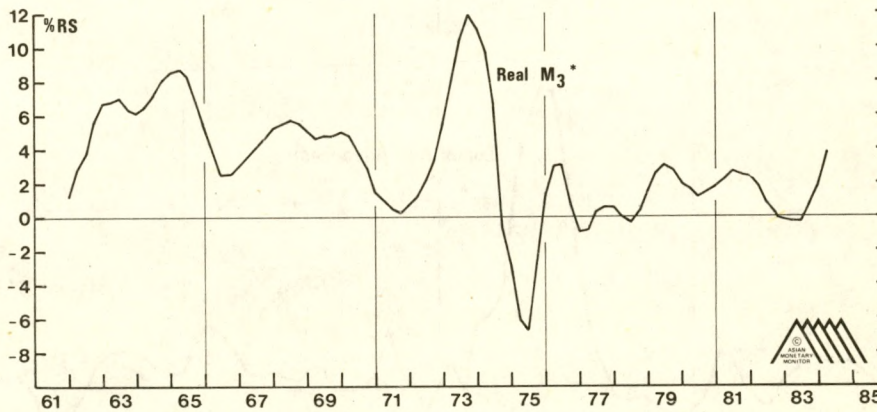
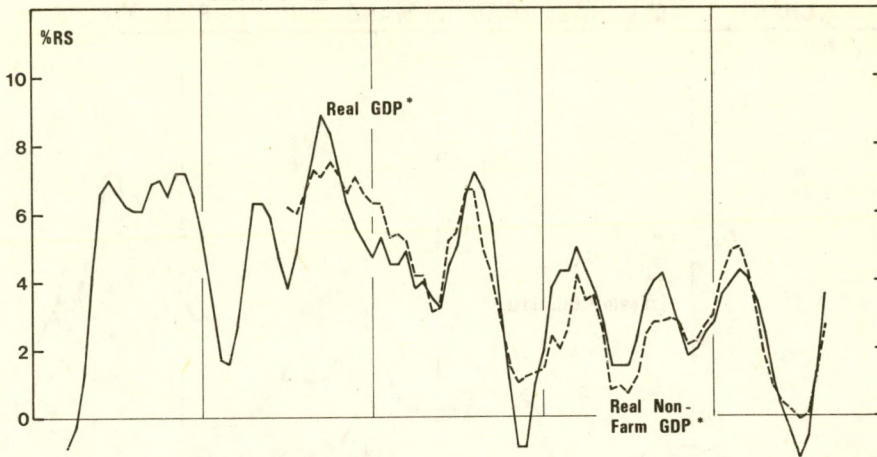
The potential for higher inflation is not, however, the only factor which may lead to higher interest rates in the wake of a strong domestic recovery; if the evidence of past business cycles is any guide one may anticipate that a cyclical rise in private sector loan demand will add to upward pressure on interest rates. Chart 7 records the recent relationship between the year-to-year rate of growth of M1, M3, the loans and advances (including bills discounted) of major trading banks and, the yield on three month Treasury Bill yields. It is evident from Chart 7 that a cyclical decline in private sector demand for trading bank assets was an important contributory cause of the cyclical decline in short term interest rates during 1982 and 1983. However, this year the demand for credit from trading banks has recovered quite rapidly, lagging the strong recovery in domestic economic activity. It is of interest to note that, so far, private capital expenditure has been a weak sector in the overall economic recovery. Private non residential fixed capital expenditure fell by 13.9%, in real terms, in the year to December 1983. If this sector of the economy does recover modestly during the latter half of this year, as suggested by recent surveys*, then upward pressure on private credit demands may intensify. Stronger growth in private credit demands will likely provide a pervasive upward bias to Australian interest rates until such time as the domestic economy begins to slow.

The advent of a floating exchange rate may eliminate any direct link between the trend in Australia's external account and the course of domestic monetary policy. Nevertheless, there may still be an indirect link between the balance of payments and local interest rates to the extent that the Australian authorities adjust the level of short interest rates in response to the trend in the Australian dollar exchange rate. In this context it is important to note that the Australian economy is likely to grow more rapidly than many of its major trading partners and this is already starting to undermine the cyclical improvement in Australia's current account (refer to Chart 3) which was evident in 1982 and 1983. Thus unless domestic interest rates are increased - thereby encouraging increased private capital inflows to Australia - it is realistic to presume that the deterioration in the overall balance of payments may continue. In the longer term this may be thought likely to induce underlying weakness in the Australian dollar on the foreign exchanges. In turn, this is likely to raise inflationary expectations in the Australian economy, particularly if domestic monetary policy remains accommodative, and the Reserve Bank could be expected to raise local interest rates. The possibility that the Reserve Bank may eventually raise domestic interest rates in order to defend the exchange rate is, fundamentally, a further reason for thinking that Australian interest rates will rise in response to a strong and potentially inflationary domestic economic recovery.

FORECAST: A large balance of payments surplus during 1983, at a time when the Reserve Bank managed the Australian dollar, combined with a weak domestic economy during the first half of the year encouraged a further easing in local money market conditions and reduced interest rates. However in contrast to 1982, the erratic decline in Australian interest rates last year was associated with rising rather falling monetary growth. The increase in monetary growth in 1983 coincided with a cyclical decline in inflation and created a strong rise in real purchasing power in the domestic economy which was undoubtedly mainly responsible for the powerful rise in the level of real economic activity. Australian interest rates are now likely to rise in the wake of this

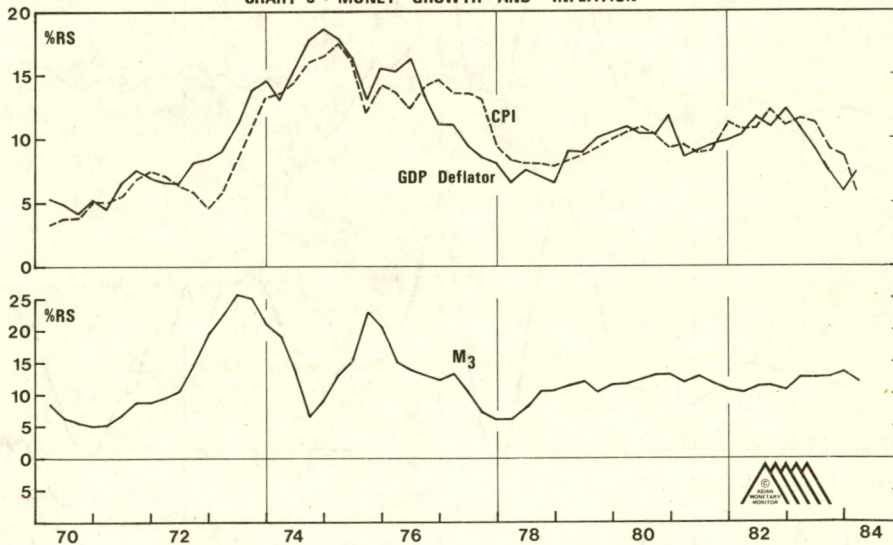
* The April/May Confederation of Australian Industry survey found that respondent firms expected business fixed capital expenditure to show "solid real increases during the first half of 1984". Private fixed capital expenditure actually rose 6.6%, in real terms, during the March quarter - the first quarterly increase since June 1982.

AUSTRALIA
CHART 5: REAL MONEY AND REAL GDP GROWTH



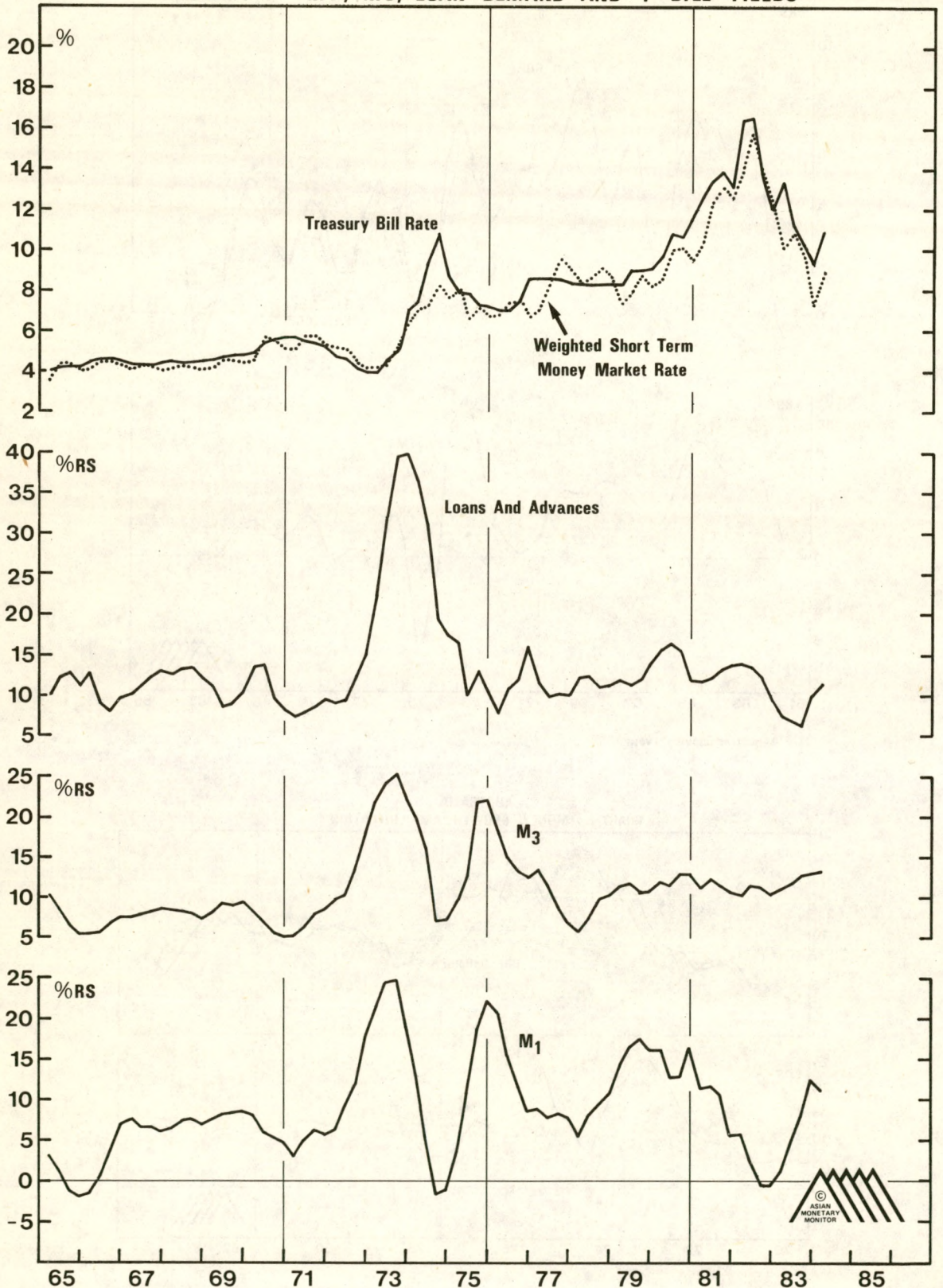
*4-quarter moving average

AUSTRALIA
CHART 6: MONEY GROWTH AND INFLATION



AUSTRALIA

CHART 7 : M1, M3, LOAN DEMAND AND T-BILL YIELDS



recovery in real GNP. Current monetary policy in Australia is likely to prove to be too accommodative to sustain inflation at present, historically moderate, levels and it is probable that short interest rates must rise in order to subdue growth in the domestic monetary aggregates. Any tightening in local monetary policy is likely to occur as private sector demands for credit rise, in the wake of domestic recovery, thereby adding further pressure towards higher interest rates. If the Australian authorities postpone a decision to pursue a more restrictive monetary policy then the potential for a deterioration in inflationary expectations, or for currency weakness, may rise. In this event, the longer term outlook for both short and long dated Australian interest rates may also be expected to deteriorate.

HONG KONG

THE ENIGMA OF HONG KONG'S FINANCIAL TRANSACTIONS WITH CHINA

One salient feature of Hong Kong's economic life in recent years has been its rapidly expanding ties with China. China replaced Japan as Hong Kong's largest supplier in 1982; it also became Hong Kong's fourth largest export market in the same year. In entrepot trade, China became the largest country of destination in 1980, and the largest country of origin as early as 1969. These trade flows are well documented by Hong Kong's generally excellent trade statistics. Investment flows, which have also been growing rapidly both ways, lack a similar official documentation, although the more spectacular investment deals have received wide publicity.

However, a relatively neglected aspect of the economic nexus is financial transactions between Hong Kong's financial institutions and their counterparts in China. Fortunately, statistics regarding these transactions are now regularly available thanks to the provisions of the amended Banking Ordinance and the Deposit-Taking Companies Ordinance. Starting from the first quarter of 1979, the external liabilities and claims of licensed banks and deposit-taking companies (DTCs) by country of origin have been regularly compiled and released on a quarterly basis by the Banking Commissioner's Office at the request of the Bank of International Settlements in Basle. The information contained therein, while by no means complete, is nevertheless useful for ascertaining Hong Kong's role as a financial centre, as well as its financial transactions with individual countries, including China.

Liabilities and claims of licensed banks and DTCs with respect to China are presented in Tables 1 and 2 respectively, while net financial transactions of all institutions are summed up in Table 3.

Several interesting features of Hong Kong-China financial transactions during the past five years may be noted. As far as gross magnitude is concerned, the most notable development is the phenomenal growth of liabilities to banks in China. For example, since March 1979 Hong Kong's licensed banks' liabilities to their counterparts have risen by 47 times to nearly HK\$20.3 billion in the first quarter of 1984. Similarly, DTCs' liabilities to Chinese banks rose from almost nothing to HK\$1.4 billion in the same period. Hong Kong licensed banks' claims on their counterparts, however, barely doubled, while DTCs' claims on Chinese banks rose rapidly until the first quarter of 1981, but since then have generally followed a sharp downtrend, so that over the whole period there was not much growth to speak of. Claims on non-bank customers rose very substantially for both the licensed banks and DTCs, although the terminal figures, at HK\$704 million and HK\$621 million respectively, remained modest relative to their domestic lendings.

The most intriguing feature however is the reversal of trend in net liabilities and claims. Prior to 1982, Hong Kong licensed banks had always maintained a net creditor status vis-a-vis China. But since the first quarter of 1982, this has been turned into a net debtor status. Moreover, the net indebtedness increased by over 90 times in barely two years to HK\$9.7 billion. For the DTCs, the reversal took place a quarter earlier in late 1981, although after certain fluctuations, and their net indebtedness at the terminal date was only about 16% higher than at the end of 1981. However, for the financial sector as a whole, as shown in Table 3, the turning point is still 1982; and the net indebtedness increased by nearly 14 times to HK\$10.4 billion, a sum which surely cannot be dismissed as being trivial.

TABLE 1

HONG KONG LICENSED BANKS:
EXTERNAL LIABILITIES TO AND CLAIMS AGAINST CHINA
(million HK dollars)

Date	Liabilities to Banks	Claims on Banks	Claims on Non-banks	Net Liabilities (-) or Claims (+)
Mar. 31, 1979	421	5,144	2	+4,725
Jun. 30, 1979	348	5,569	10	+5,231
Sep. 30, 1979	393	5,623	36	+5,266
Dec. 31, 1979	205	5,797	109	+5,701
Mar. 31, 1980	661	5,893	154	+5,386
Jun. 30, 1980	1,160	5,647	189	+4,676
Sep. 30, 1980	1,279	5,551	345	+4,617
Dec. 31, 1980	773	6,631	399	+5,352
Mar. 31, 1981	422	5,967	439	+5,984
Jun. 30, 1981	1,779	5,556	514	+4,291
Sep. 30, 1981	2,838	5,612	569	+3,343
Dec. 31, 1981	4,419	6,367	618	+2,567
Mar. 31, 1982	6,519	6,105	314	-100
Jun. 30, 1982	7,757	5,503	244	-2,010
Sep. 30, 1982	8,038	5,093	268	-2,677
Dec. 31, 1982	10,562	5,349	280	-4,933
Mar. 31, 1983	12,016	6,255	293	-5,468
Jun. 30, 1983	13,092	7,411	315	-5,366
Sep. 30, 1983	15,466	8,023	442	-7,001
Dec. 31, 1983	16,329	8,467	529	-7,333
Mar. 31, 1984	20,280	9,866	704	-9,710

Source: Hong Kong Monthly Digest of Statistics

TABLE 2

HONG KONG DEPOSIT-TAKING COMPANIES:
EXTERNAL LIABILITIES TO AND CLAIMS AGAINST CHINA
(million HK dollars)

Date	Liabilities to Banks	Claims on Banks	Claims on Non-banks	Net Liabilities (-) or Claims (+)
Mar. 31, 1979	-	96	-	+96
Jun. 30, 1979	-	102	-	+102
Sep. 30, 1979	-	100	16	+116
Dec. 31, 1979	8	40	-	+32
Mar. 31, 1980	1	190	1	+190
Jun. 30, 1980	73	490	28	+445
Sep. 30, 1980	171	499	62	+390
Dec. 31, 1980	208	510	106	+445
Mar. 31, 1981	246	602	231	+587
Jun. 30, 1981	292	549	230	+487
Sep. 30, 1981	722	598	188	+64
Dec. 31, 1981	986	268	121	-597
Mar. 31, 1982	800	24	163	-613
Jun. 30, 1982	951	93	217	-641
Sep. 30, 1982	668	-	264	-404
Dec. 31, 1982	1,026	96	405	-525
Mar. 31, 1983	1,823	56	321	-1,446
Jun. 30, 1983	2,122	28	289	-1,805
Sep. 30, 1983	2,376	179	329	-1,868
Dec. 31, 1983	2,168	18	328	-1,822
Mar. 31, 1984	1,429	123	612	-694

Source: as for Table 1

TABLE 3

NET FINANCIAL TRANSACTIONS BETWEEN CHINA & HONG KONG*

(million Hong Kong dollars)

<u>Date</u>	<u>Licensed Banks</u>	<u>Deposit-taking Companies</u>	<u>Total</u>
Mar. 31, 1979	+4,725	+96	+4,821
Jun. 30, 1979	+5,231	+102	+5,333
Sep. 30, 1979	+5,266	+116	+5,382
Dec. 31, 1979	+5,701	+32	+5,733
Mar. 31, 1980	+5,386	+190	+5,576
Jun. 30, 1980	+4,676	+445	+5,121
Sep. 30, 1980	+4,617	+390	+5,007
Dec. 31, 1980	+5,352	+445	+5,797
Mar. 31, 1981	+5,984	+588	+6,572
Jun. 30, 1981	+4,291	+487	+4,778
Sep. 30, 1981	+3,343	+64	+3,407
Dec. 31, 1981	+2,567	-597	+1,970
Mar. 31, 1982	-100	-613	-713
Jun. 30, 1982	-2,010	-641	-2,651
Sep. 30, 1982	-2,677	-404	-3,081
Dec. 31, 1982	-4,933	-525	-5,458
Mar. 31, 1983	-5,468	-1,446	-6,914
Jun. 30, 1983	-5,366	-1,803	-7,169
Sep. 30, 1983	-7,001	-1,868	-8,869
Dec. 31, 1983	-7,333	-1,822	-9,155
Mar. 31, 1984	-9,710	-694	-10,404

* A negative sign denotes net liabilities to China, while a positive sign denotes net claims on China.

Source: as for Table 1

As is also clear from Table 3, even before 1982, Hong Kong's net claims against China had shown a discernible downtrend. Thus, after reaching their peak in the first quarter of 1981 at HK\$6.6 billion, they fell by 70% over the next few quarters to less than HK\$2 billion.

Hong Kong's pre-1982 creditor status seems relatively easy to explain. By the late seventies, the territory was already well established as a major financial centre, with a large congregation of international financial institutions eager to lend to China. On China's part, the launching of the ambitious modernization programme, and the adoption of a more liberal and outward-looking financial policy, also occurred in the late seventies. In such an environment, it was hardly surprising to find Hong Kong emerging as a sizeable creditor to China.

But how about the declining trend in Hong Kong's net claims since 1981? Writing two years ago about this topic, I tried to explain it in terms of China's retrenchment in capital investment during 1979-81, and its distaste for borrowing from foreign commercial banks because of what China considered the exorbitantly high level of interest rates prevailing from 1980 onwards in international financial markets.**

** Y.C. Jao, "Hong Kong's Role in Financing China's Modernization", in A.J. Youngson (ed.), China and Hong Kong: the Economic Nexus (Hong Kong: Oxford University Press, 1983), pp. 29-30.

Since then, the level of international interest rates in financial centres has fallen from its peak in 1980-81, even though many economists would still regard current levels as not sufficiently low to stimulate a robust world-wide recovery in trade and investment. At the same time, China has completed its period of economic adjustment reasonably well, and appears ready for a renewed acceleration of its modernization drive. Normally, one would expect, as the present writer did, that China would re-enter the international market as a net borrower, and that Hong Kong would strengthen its creditor status in view of its position as a leading financial centre. Yet the fact remains that, since 1982, Hong Kong has become heavily indebted to China on a net basis.

Before one attempts to unravel this enigma, a methodological note is in order. According to the Banking Commissioner's Office, liabilities and claims are analysed with reference to the country of the branch making or accepting the deposit, and not by the country of its head office. Thus, for example, a claim on the London branch of a US bank is reported against the United Kingdom, and not against the USA. By the same token, the Bank of China's branches and subsidiaries in Hong Kong are treated as Hong Kong entities. In theory, liabilities and claims in the tables may pertain, for example, to a foreign bank's branch inside China. In practice, however, this quibble is purely academic, since of the 55 foreign banks now in China, only four (The Bank of East Asia, The Chartered Bank, Hongkong & Shanghai Banking Corporation, and Overseas Chinese Banking Corporation) are allowed to retain five branches in Shanghai and Xiamen. Moreover, even these five branches are merely leftovers from the pre-Liberation days --- the remnants of substantial network of branches of foreign institutions relentlessly reduced to almost nothing since 1949. Their operations seem confined to foreign trade financing. The fact is that since the establishment of the People's Republic, not a single foreign bank or overseas Chinese bank has been allowed to establish a new branch in China. A foreign financial institution is only allowed to set up a representative office or a liaison office. But as is well known, under banking regulations, a representative office is expressly forbidden to engage in profit-making business, such as taking deposits, granting loans, and transferring money. Thus, it is safe to assume that the item "liabilities to banks" means liabilities of Hong Kong institutions to banks incorporated in China only, and not branches of foreign banks in China.

One possible interpretation of Hong Kong's growing indebtedness to China, purely from the perspective of contemporary banking practice, is that the Bank of China's branches and subsidiaries in Hong Kong have learned the trick of "liability management", an innovation pioneered by US banks in the early sixties. There are many manifestations of this approach, but one familiar technique is for a bank to fund its local lendings by borrowing from its head office or overseas offices. For instance, when the Bank of China branch in Hong Kong takes a deposit from its head office and on-lends it to a Hong Kong firm, this transaction will show up in the statistical return as "liabilities to banks in China". The known facts that two-way trade and investment flows have been expanding rapidly, and that Hong Kong businessmen are strongly supported by the Bank of China Group for their involvement in various projects in the Special Economic Zones, are consistent with this interpretation.

An alternative interpretation is more broadly based and takes into account the changing political environment. Hong Kong during the past two years has been going through a traumatic period of confidence crisis, and financially, this has been reflected in the collapse of the property and stock markets, the liquidity squeeze on many DTCs and some licensed banks, and most seriously, the run on the Hong Kong dollar which nearly brought down the whole financial system in September 1983. Most of these difficulties can be directly or indirectly traced to the loss of confidence after China's official announcement that it would recover sovereignty over the whole Hong Kong area. At the time of the announcement, China also promised to take a series of measures to stabilise the Hong Kong economy. Could the massive injection of funds into Hong Kong be one of these measures? Certainly China has nothing to gain from a

financially ruined Hong Kong. Moreover, China does have the financial muscle to support Hong Kong through bank loans and other forms of credit. As shown in Table 4, China's foreign exchange reserves, exclusive of gold stock, increased nearly seven fold to US\$14.3 billion during 1979-83. Even though this amount is still small relative to the country's size and development needs, China's capability of extending short-term banking facilities on strictly commercial terms is not in doubt. Frequent press reports about the Bank of China's participation in international loan syndication also lend support to this line of reasoning.

TABLE 4
CHINA'S FOREIGN EXCHANGE AND GOLD RESERVES

<u>End of Year</u>	<u>Foreign Exchange</u> (million US\$)	<u>Gold</u> (million troy ounces)
1979	2,154	12.80
1980	2,262	12.80
1981	4,773	12.67
1982	11,125	12.67
1983	14,342	12.67

Source: Zhongguo Jinrong (China Banking and Finance)

It is also known that China has been helping local financial institutions faced with liquidity problems. Jiang Wengui, Vice-Chairman of the Bank of China and General Manager of the Hong Kong branch, confirmed in an interview on May 24 that his bank has supported in the past individual Hong Kong and Macau banks in difficulties, and will continue to do so in future since the "stabilisation of the Hong Kong and Macau financial markets is what we should do". The increasing net indebtedness of Hong Kong DTCs to China's banks, shown in Table 2, is also suggestive.

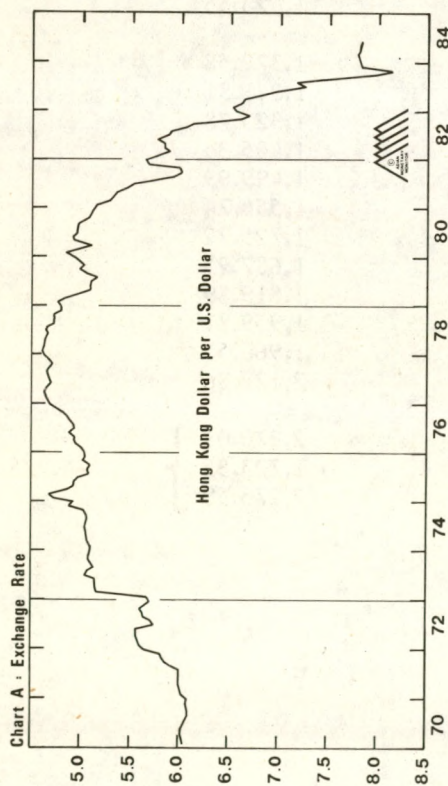
The available data do not, however, provide sufficient details about the sources and uses of funds. We do not know, for instance, the specific channels or mechanisms through which Chinese money flows into Hong Kong. We do not know who are the ultimate borrowers of such funds. We are also in the dark about the uses of these funds, even by broad industrial sectors. Given the traditional secretiveness of China's financial institutions, and the confidentiality rule observed by the Hong Kong Banking Commissioner's Office, the enigma will remain for some time to come.

Finally, it can hardly be over-emphasised that in financial matters, there is no such thing as a permanent statistical trend. Nevertheless, the growing financial nexus does suggest that, from a purely economic point of view, China has a strong vested interest in Hong Kong's viability.

APPENDIX

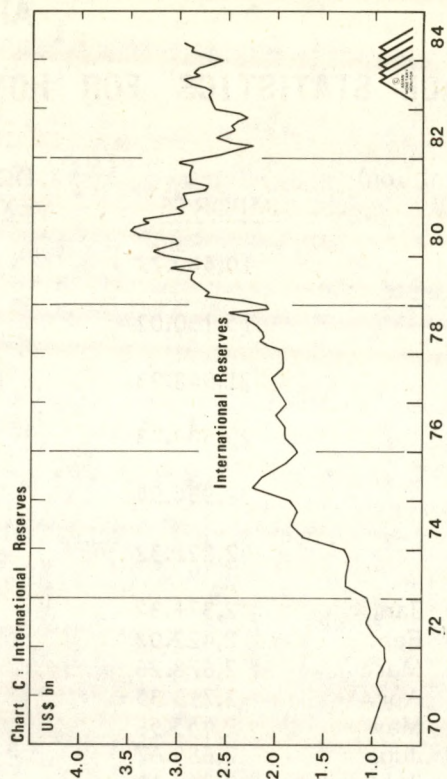
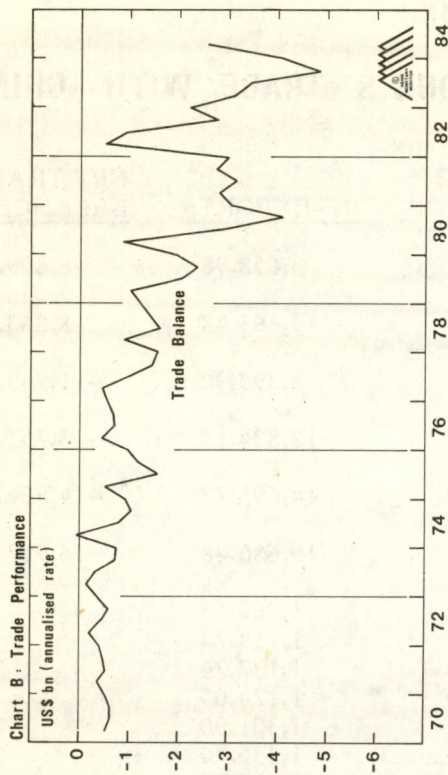
TRADE STATISTICS FOR HONG KONG'S TRADE WITH CHINA

(HK\$ million)		<u>IMPORTS</u>	<u>DOMESTIC EXPORTS</u>	<u>RE-EXPORTS</u>	<u>NET TRADE BALANCE</u>
1978		10,549.77	81.17	3,658.98	-6,809.62
1979		15,130.02	603.30	5,663.48	-8,863.24
1980		21,948.23	1,605.18	8,393.90	-11,949.15
1981		29,509.73	2,924.19	12,834.15	-13,751.39
1982		32,934.94	3,806.31	14,693.73	-14,434.90
1983		42,821.32	6,223.33	19,680.48	-16,917.51
1982	Jan.	2,371.34	292.62	1,060.53	
	Feb.	2,422.02	285.01	1,114.74	
	Mar.	2,678.26	350.20	1,137.74	
	Apr.	2,713.35	309.60	1,174.05	
	May	2,455.56	281.61	1,301.90	
	Jun.	2,684.67	301.50	1,135.70	
	Jul.	2,860.14	305.19	1,248.49	
	Aug.	2,685.61	311.31	1,251.12	
	Sep.	2,879.07	324.27	1,236.31	
	Oct.	2,875.03	294.41	1,248.79	
	Nov.	2,869.99	337.51	1,278.34	
	Dec.	3,484.27	417.67	1,523.55	
1983	Jan.	2,964.08	352.21	1,372.58	
	Feb.	2,166.00	282.97	1,241.81	
	Mar.	2,941.46	427.40	1,325.78	
	Apr.	3,056.65	431.49	1,405.35	
	May	3,073.09	493.68	1,499.99	
	Jun.	3,573.44	509.40	1,554.74	
	Jul.	3,625.22	500.71	1,725.72	
	Aug.	3,813.47	576.57	1,687.25	
	Sep.	3,799.08	581.46	1,819.89	
	Oct.	4,183.82	653.51	1,959.81	
	Nov.	4,427.93	692.10	1,966.55	
	Dec.	5,196.89	721.85	2,122.86	
1984	Jan.	4,508.38	669.69	2,270.01	-4,278.37
	Feb.	3,552.01	529.23	1,723.35	
	Mar.	4,469.17	785.33	2,273.58	



There is little likelihood that the Hong Kong dollar will trade significantly (i.e. more than about 2%) away from the US\$1=HK\$7.80 pegged rate for new Certificates of Indebtedness anytime in the currently foreseeable future.

The circumstances surrounding the introduction of Hong Kong's unique 'currency peg' on October 15th, 1983 and its operation since that date have been discussed in recent issues of AMM. From the point of view of currency forecasting the key point to note is that Hong Kong's monetary system is now akin to a gold standard system, and is not to be likened to the type of fixed exchange rate system typified by Bretton Woods. Under Hong Kong's present system the authorities stand ready to provide enough reserves of foreign exchange to cover the outstanding note issue, and not to cover the potentially unlimited demand for foreign exchange reserves posed by cumulative balance of payments deficits (the latter being the case under the standard type of fixed or managed exchange rate system). Consequently, as long as the authorities remain prepared to allow the effects of adaption to external or other shocks to emerge in the form of interest rate movements, then they have no need to alter the exchange rate peg.



During the first two months of this year there was upward pressure on the Hong Kong dollar as the US dollar weakened and foreign exchange market participants speculated that the Financial Secretary would announce a revaluation of the peg rate in his February 29th budget speech. Capital inflows into the Hong Kong dollar and a strong trade performance for the two months (Domestic exports rose by 50.9% year-to-year in the first quarter against import growth of 42.9%) exerted downward pressure on interest rates, with overnight interbank rates falling close to zero and HKAB best lending rates reaching a low of 8½% by mid-March. Consequently money growth continued to surge with Hong Kong dollar M3 growth reaching 24.8% year-on-year by March, up from yearly growth of only 0.1% in September 1983.

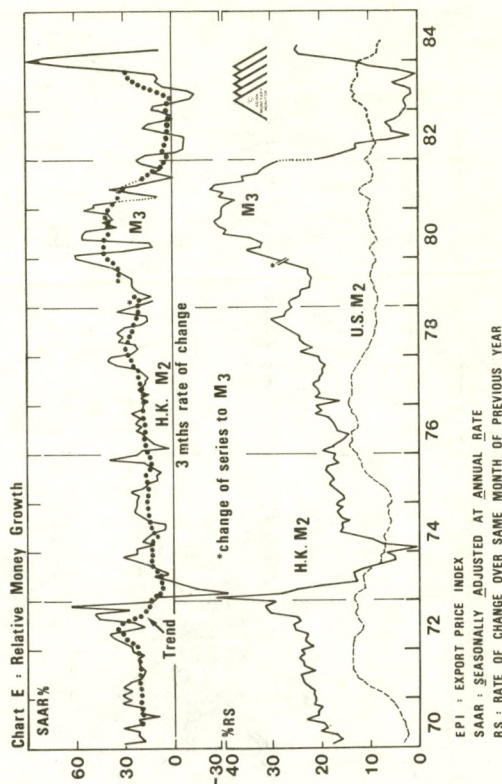
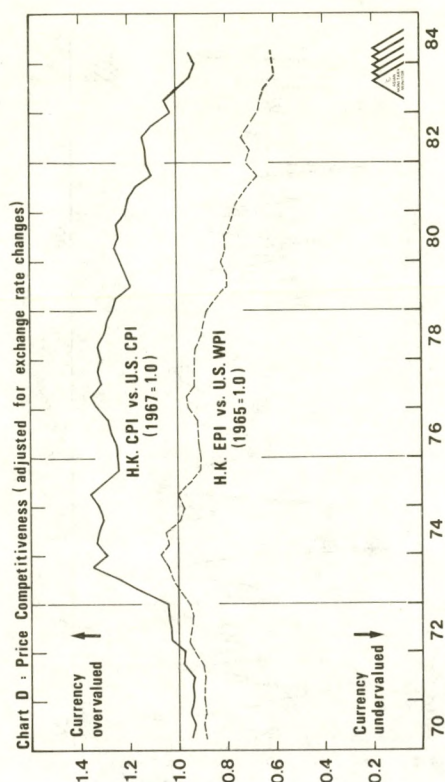
Since March these economic forces have reversed somewhat as the US dollar has regained its strength on the foreign exchange markets and it has become clear that no revaluation of the Hong Kong dollar is imminent. Hong Kong dollar M3 declined in both March and April (by 0.7% and 1.6% month-on-month respectively) and interest rates have been on an uptrend since mid-March. The most recent rise in HKAB best lending rates, in late May, took Hong Kong's 'prime' back to 12 3/4%, more than 4% above the lows of only 2 months previously.

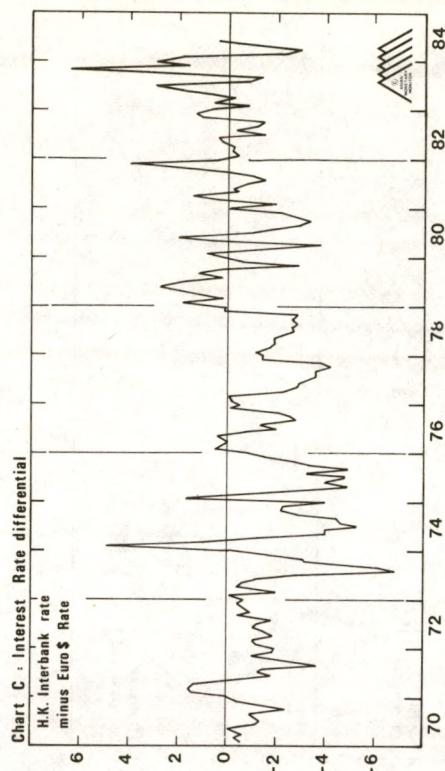
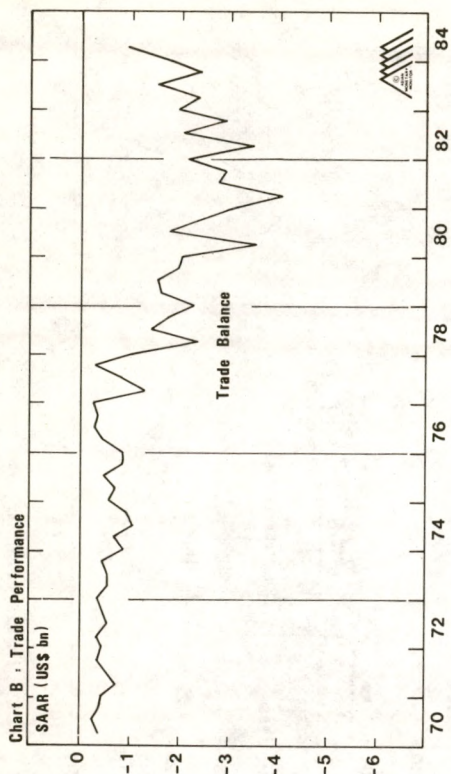
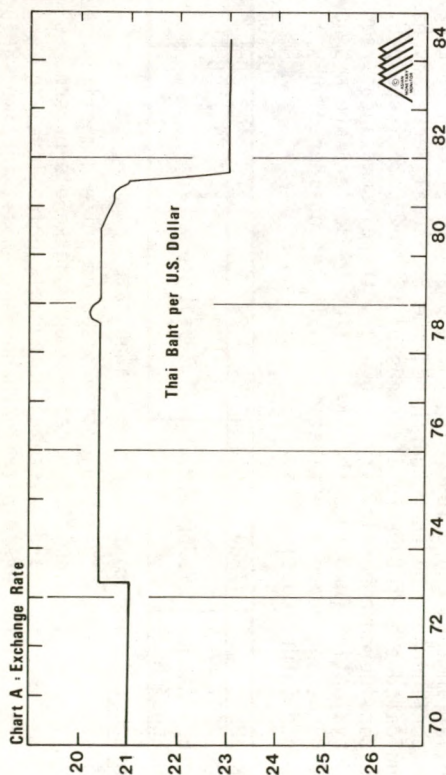
It is clear, and obvious from official statements, that the authorities in Hong Kong are not prepared to devalue the Hong Kong dollar in the future for fear of the possible effects of a devaluation on confidence. On the other hand, the Financial Secretary has indicated that future revaluations of the new note issue peg should be considered a possibility. However, the circumstances required for a revaluation (namely a sharply falling US dollar) are not now in evidence and hence a revaluation should be considered only as a remote future possibility.

HK\$/US\$	ACTUAL			FORECAST	
	1984	Q1	Q2	Q3	Q4
FORECAST A				7.75-7.85	7.75-7.85
Actual Range	7.765-7.818		7.799-7.819		
FORECAST B				-	-

Forecast A The most likely exchange rate.

Forecast B The usual projection based on price competitiveness has been omitted here. Under Hong Kong's present 'US dollar standard' system, the overall price level in Hong Kong rather than the exchange rate will, in time, adjust to price levels in the USA, and hence an exchange rate forecast based on purchasing power parity would be inappropriate.





Between August last year and February of this year the Thai Baht came under increasing pressure in the foreign exchange markets as there were widespread fears of an imminent devaluation. These fears stemmed largely from a sharp deterioration in Thailand's trade account (see Chart B) but became self-reinforcing as private enterprises were discouraged from borrowing in overseas capital markets by the increasing cost of forward cover for US dollar borrowings, as well as by the rising trend in US interest rates. The fall in private capital inflows contributed further to a deterioration in the overall balance of payments which continued through January of this year.

The Bank of Thailand (BOT) resisted pressure to devalue largely because the Thai Central Bank was concerned about the implications of a devaluation for domestic monetary growth. Money growth in Thailand has been very high for more than two years with M2 having grown by 24.0% in 1982 and 23.2% in 1983 (see Chart E). A devaluation would have undoubtedly encouraged a surge in private capital inflows which would have further raised money growth. Instead BOT allowed speculation against the Baht to emerge in the form of higher domestic interest rates, culminating eventually in the Finance Ministry's decision to raise the ceiling interest rate for certain types of

commercial bank lending in March.

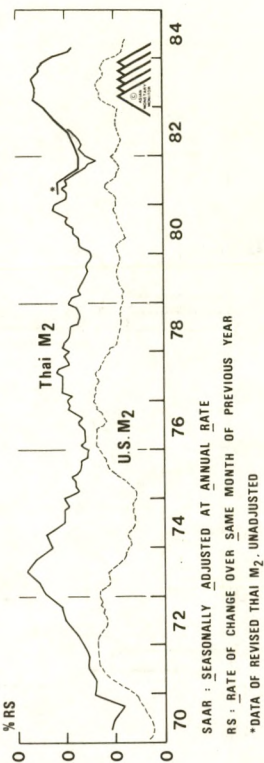
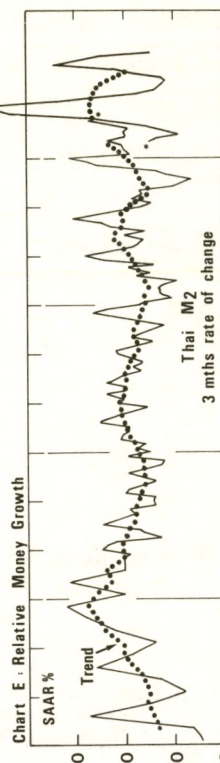
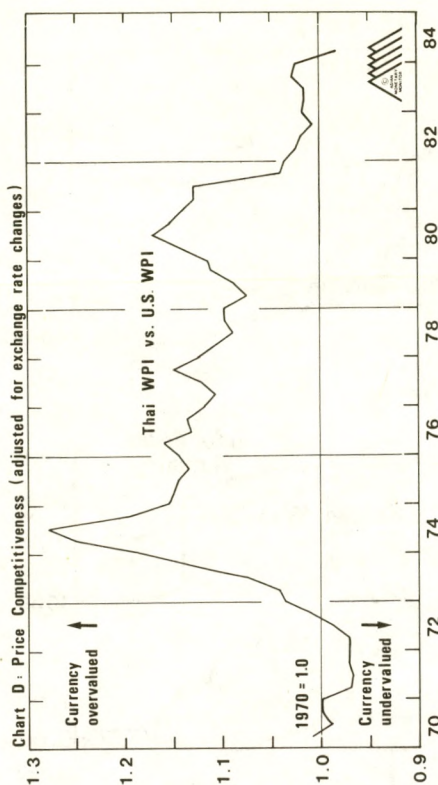
The longer term outlook for the Baht now depends critically on developments in the US economy. By March BOT's obvious commitment to the existing exchange rate and the height of domestic interest rates had led to an easing in speculation against the Baht and large capital inflows took the overall balance of payments into surplus for that month. However, the trade balance has remained in chronic deficit as import growth remains high and Thailand's main commodity exports - rice, tapioca, sugar and rubber - have suffered a period of renewed price weakness on world markets this year. The deficit in the first quarter was running at a similar annual rate to last year's record Baht 89 billion deficit. If the trade account fails to improve and the US dollar remains strong as US interest rates continue to rise then undoubtedly the Baht will encounter a further period of pressure in the foreign exchange markets.

The BOT is currently relying on credit controls in an attempt to bring money growth under control and it would be wrong for the Central Bank to devalue while money growth remains high. However, money growth did fall sharply in the first quarter and by March the year-on-year rate of M2 growth was down to 18.5%, its lowest level for nearly two years. It would need some continuation of this trend and also continued strength in the US dollar before a devaluation could conceivably be a possibility, and in the medium term the exchange rate for the Baht is likely to remain fixed at the current rate. Nevertheless, if the Federal Reserve tightens US monetary policy then the BOT may take the opportunity afforded by a decline in Thai money growth to lower the Baht exchange rate.

Baht/US\$	ACTUAL		FORECAST	
	1984	Q1	Q2	Q3
FORECAST A				
Actual Range		23.0	23.0	23.0
FORECAST B				
			22.6	22.6

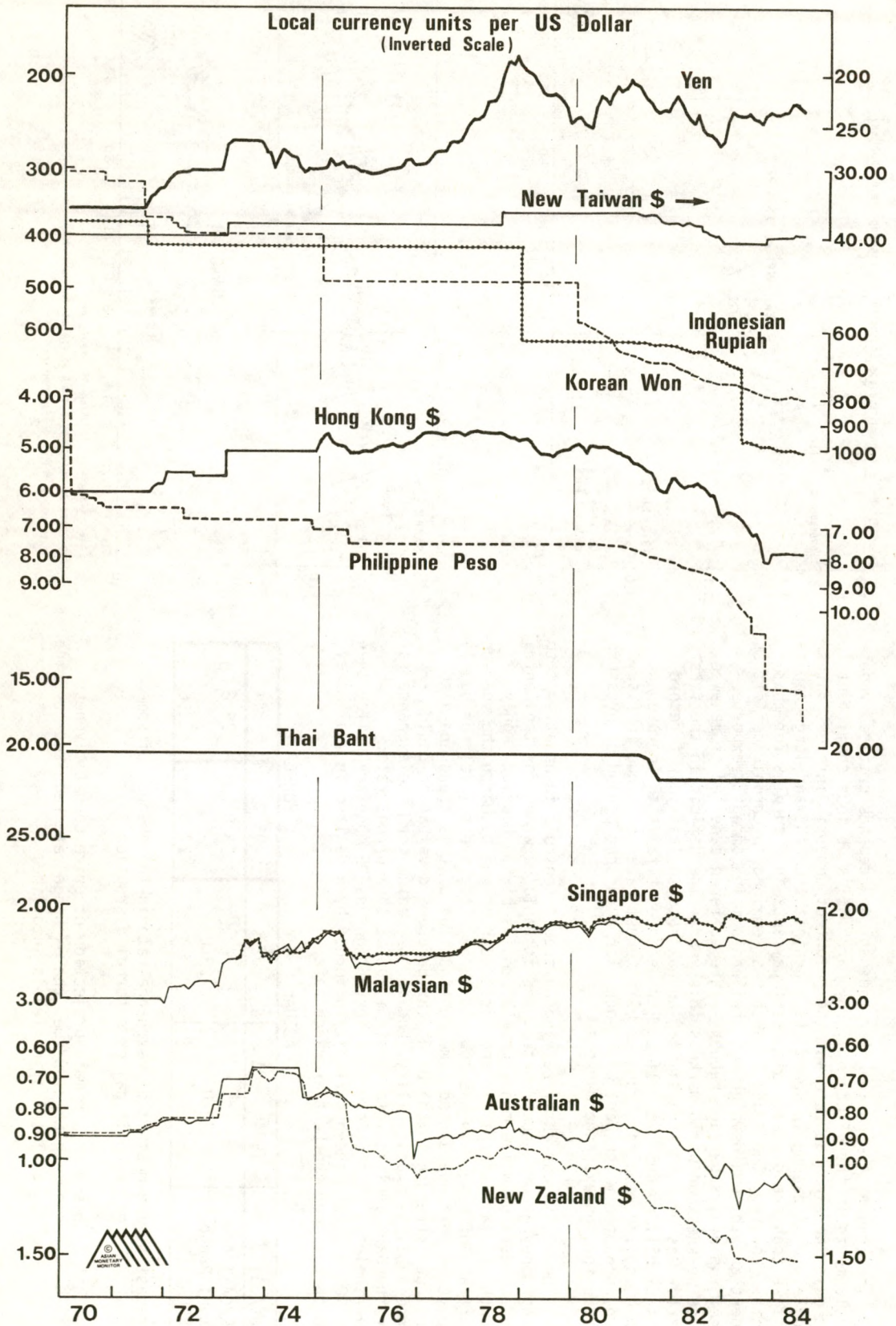
Forecast A The most likely exchange rate in the absence of some major political or external disruption.

Forecast B based on a simple projection of price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line.



SAAR : SEASONALLY ADJUSTED AT ANNUAL RATE
RS : RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR
*DATA OF REVISED THAI M2, UNADJUSTED

EXCHANGE RATES IN THE FAR EAST

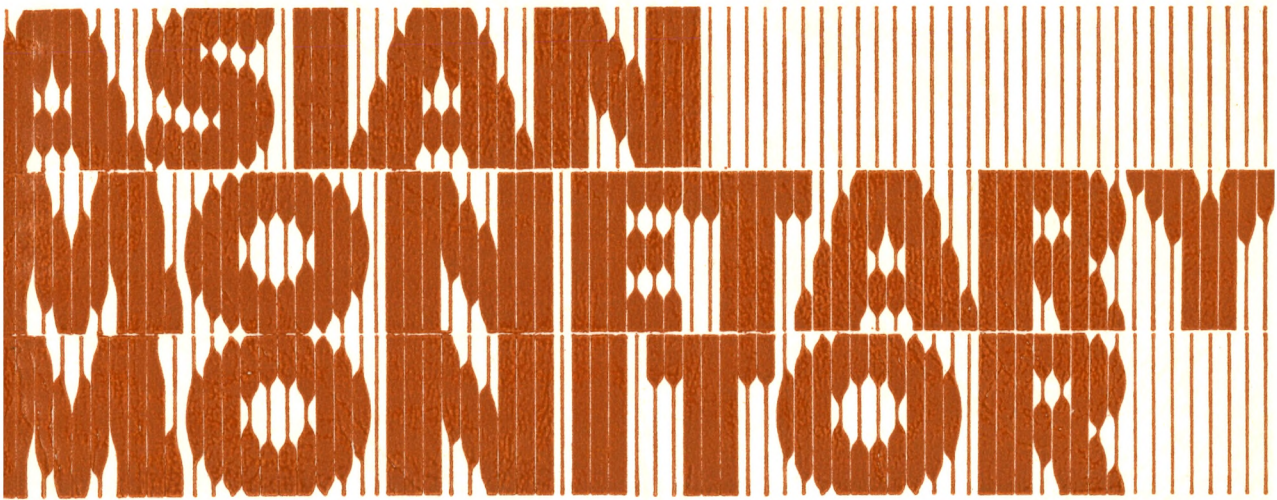




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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

AUSTRALIA

IS M3 THE APPROPRIATE MONETARY AGGREGATE TO TARGET ?

During his recent budget statement the Australian Treasurer announced a reduction in the target rate of growth in M3 from 10%-12% in 1983/84 to 8%-10% in 1984/85. M3 has been the Australian authorities' standard target aggregate since monetary growth targets were first introduced in the Australian context in 1976. However, the Treasurer also announced that the authorities would review the conduct of monetary policy this year not only with reference to M3 growth relative to its target, but also with reference to a measure of "broad money", M6.

The M3 aggregate is defined to include notes and coin held by the non bank public plus deposits by the non bank private sector at trading banks and savings banks. "Broad money" is equal to M3 plus borrowings from the non bank private sector by permanent building societies, credit corporations, authorised money market dealers, pastoral finance companies, money market corporations and cash management trusts, less borrowings by authorised money market dealers from this group of non bank financial intermediaries. "Broad money", therefore includes the non-bank private sector's deposits at non bank financial intermediaries as well as at authorised trading banks and savings banks. "Broad money" is a substantially larger aggregate than M3, amounting to A\$128.2 billion in June 1984 compared with A\$76.8 billion for M3.

The rationale for using the "broad money" aggregate as a reference measure in conducting monetary policy this year arises out of the Australian authorities' policy to deregulate partially the local banking system. The abolition of certain controls on trading and savings banks' deposit rates will, it is thought, enhance these institutions' ability to compete for deposits. Thus just as in the US where bank deregulation and the introduction of Bank Money Market Funds and Negotiable Order of Withdrawal accounts exacerbated, it is argued, the trend towards higher growth in US M1 during the first half of 1983, so the Australian authorities expect that reduced controls on bank deposit rates may lead to higher growth in M3 and somewhat slower growth in deposits at non-bank financial intermediaries.

Whilst it is desirable that the Reserve Bank should inform participants in Australia's capital markets of its objective of achieving its M3 target subject to growth in "broad money" the question arises whether the wider monetary aggregates are in fact the appropriate intermediate targets for monetary policy. Should the authorities be paying greater attention to growth in the narrow monetary aggregates, such as M1?

Chart 1 records the recent growth in M3, M1 and the monetary base in Australia. A noteworthy feature of Chart 1 is the divergence between the growth in M1 and M3 in recent years. In particular, the growth in M3 has been comparatively stable and high over the last five years whereas the growth in M1 has been more cyclical. This suggests that there may be a problem involved in the interpretation of Australia's monetary statistics: the trend in M3 suggests that actually monetary policy in Australia may have been relatively unchanged since 1978. However such an interpretation is hardly compatible with other indicators of the impact of monetary policy in the Australian economy. For example, the strongly inverse yield curve during the first half of 1982 and the output, employment, share price and housing market indicators each suggest that monetary policy was restrictive during 1982 and are each consistent with the view that policy was eased substantially during 1983. In addition, the relatively stable growth in M3 in the 1978-1982 period gave little hint of the ensuing cyclical decline in inflation - a trend which was in evidence before the introduction of the Prices and Wages Accord in April 1983. By contrast, the growth in M1 appears in practice to have recorded more accurately the underlying trend in monetary policy. The substantial contraction in M1

AUSTRALIA: CHART 1

MONETARY GROWTH IN AUSTRALIA SINCE 1970



growth between 1980 and 1982 did foreshadow the 1982 recession and the subsequent decline in inflation in a manner which was consistent with monetary theory. Moreover, the subsequent rapid growth in M1 during 1983 was associated with a range of developments - sharply reduced short interest rates, a return to a positively sloped yield curve, strong rises in industrial stock market values and subsequent large increase in nominal GNP - which one would normally associate with a reflationary monetary policy.

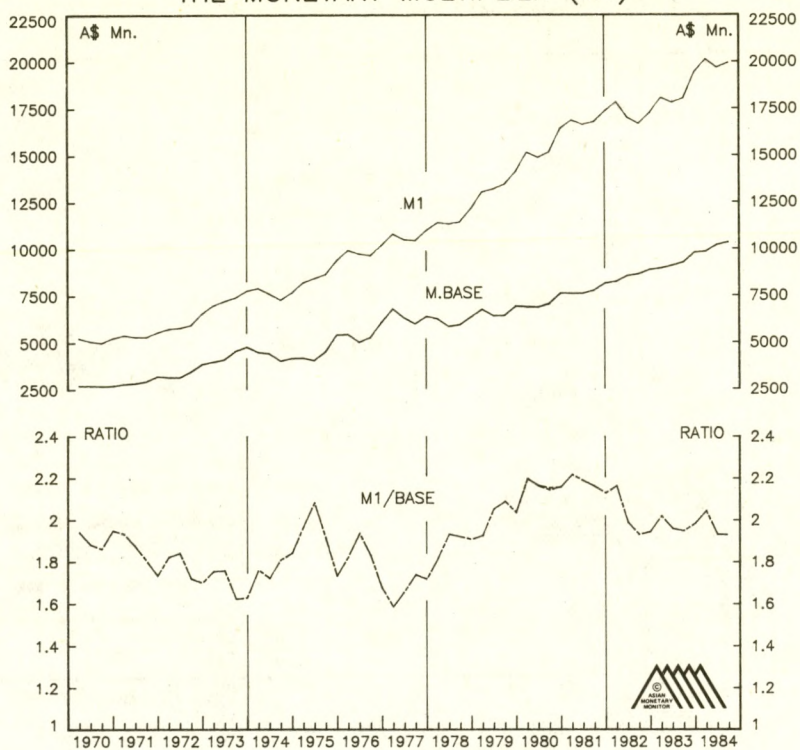
The evidence from the recent business cycle appears to suggest that the authorities' focus in targeting a broader monetary aggregate may risk ignoring valuable information concerning the effective stance of their policy which is contained in the growth of the narrower aggregates.

The basic criteria for choosing a particular monetary aggregate as an intermediate target for monetary policy are, first, that the authorities are in a position to be able to control the growth rate of the chosen aggregate and, second, that changes in the growth of the aggregate have a predictable and relatively stable impact on changes in the level of nominal GNP. The test for the first criterion is that the behaviour of the monetary multiplier (the ratio between the level of the chosen monetary aggregate and the level of the monetary base) be relatively stable, whilst that for the second criterion depends upon the stability and predictability of the income velocity of the chosen monetary aggregate.

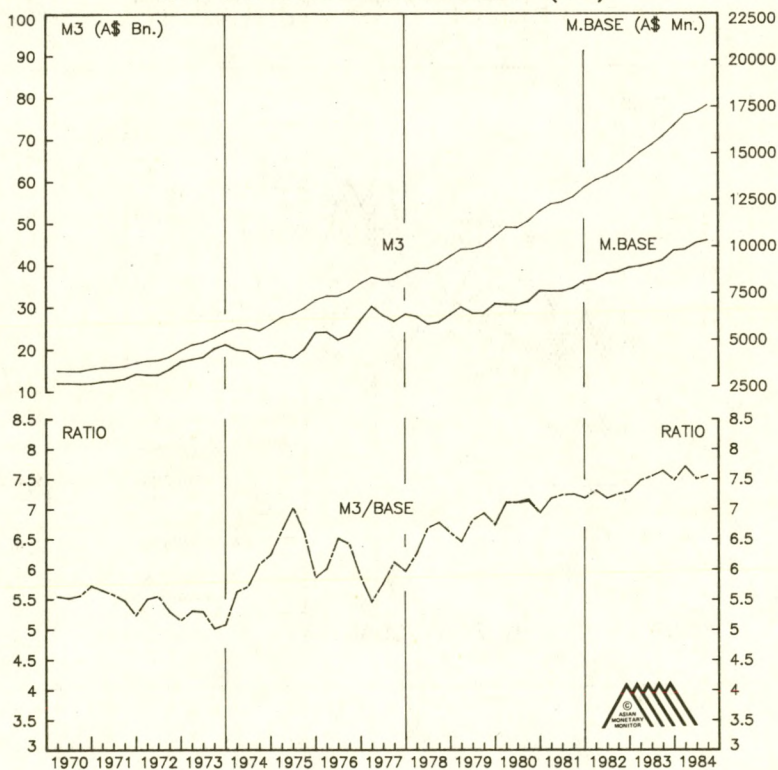
Charts 2 and 3 record the monetary multipliers for M1 and M3. The monetary base in Australia is defined here (using the Reserve Bank definition) as holdings of notes and coins by the private sector, plus commercial banks' deposits with the Reserve Bank and Reserve Bank liabilities to the non-bank private sector. This definition of the monetary base is, therefore, a narrow one including only liabilities of the central bank and excluding liabilities of the Commonwealth Government. It could be argued that this narrow definition of the monetary base is not strictly appropriate for the purposes of monetary control in Australia. The reason for this is that by convention Australian trading banks hold a minimum proportion of their assets, equivalent to 18% of their deposit liabilities in the form of Liquid and Government Securities (the LGS ratio).

Thus there are essentially two ways of regarding the monetary significance of the LGS ratio. First, to the extent that banks are unable to increase their deposit liabilities in contravention of the LGS ratio, banks' LGS assets might be regarded as part of the reserve component of a "broad" definition of the monetary base (i.e. where the monetary base is defined to include certain liabilities of the government as well as liabilities of the Reserve Bank). Alternatively, one might regard changes in trading banks' holding of government securities as having a monetary impact through changes in the monetary multiplier (where the monetary base is narrowly defined to include only liabilities of the Reserve Bank). For example, to the extent that trading banks reduce their holdings of government obligations through sales to the non bank private sector there will be a corresponding reduction in the money supply but no change in the level of the narrowly defined monetary base: the monetary multiplier will, therefore, decline. If, alternatively, trading banks increase their holding of government obligations through purchases direct from the Treasury there will be a corresponding decline in the level of the monetary base but no change in the level of the money supply: the monetary multiplier will therefore rise. However, in both of these instances the change in the monetary multiplier is a 'first order' effect of the decrease or increase in the government securities holdings of the trading banks. Although it may become more permanent if, as a result of the processes described, interest rates change so as to affect the public's desired cash to deposit ratio, the process through which this might happen is essentially no different from that which could occur in a monetary system where there is no legislated LGS ratio.

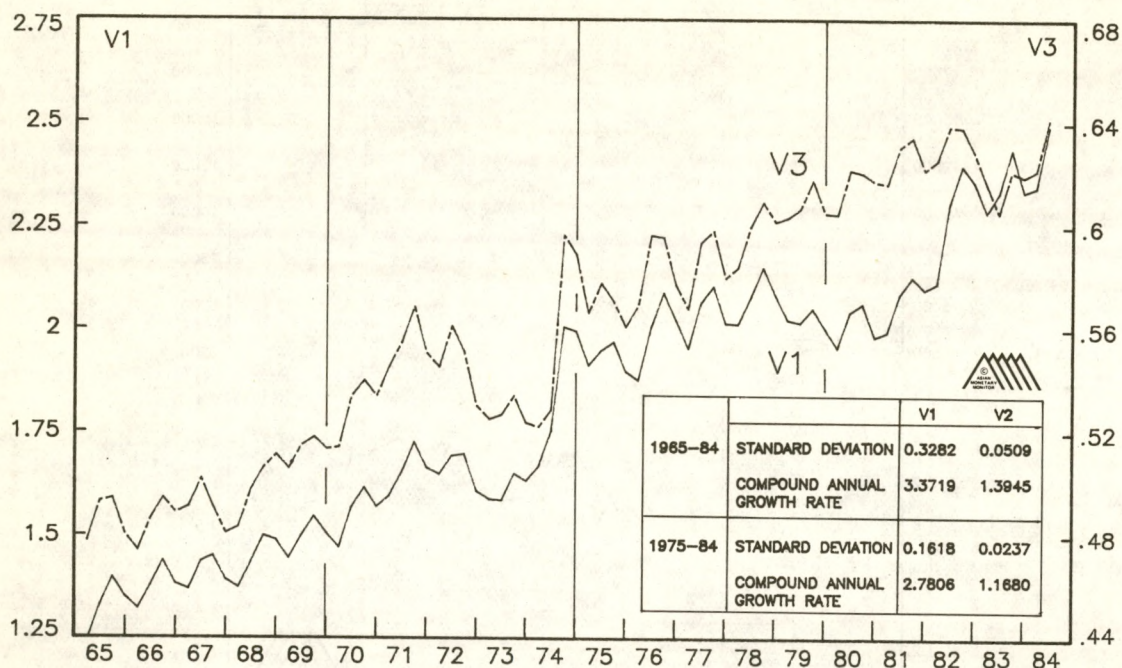
AUSTRALIA: CHART 2 THE MONETARY MULTIPLIER (M1)



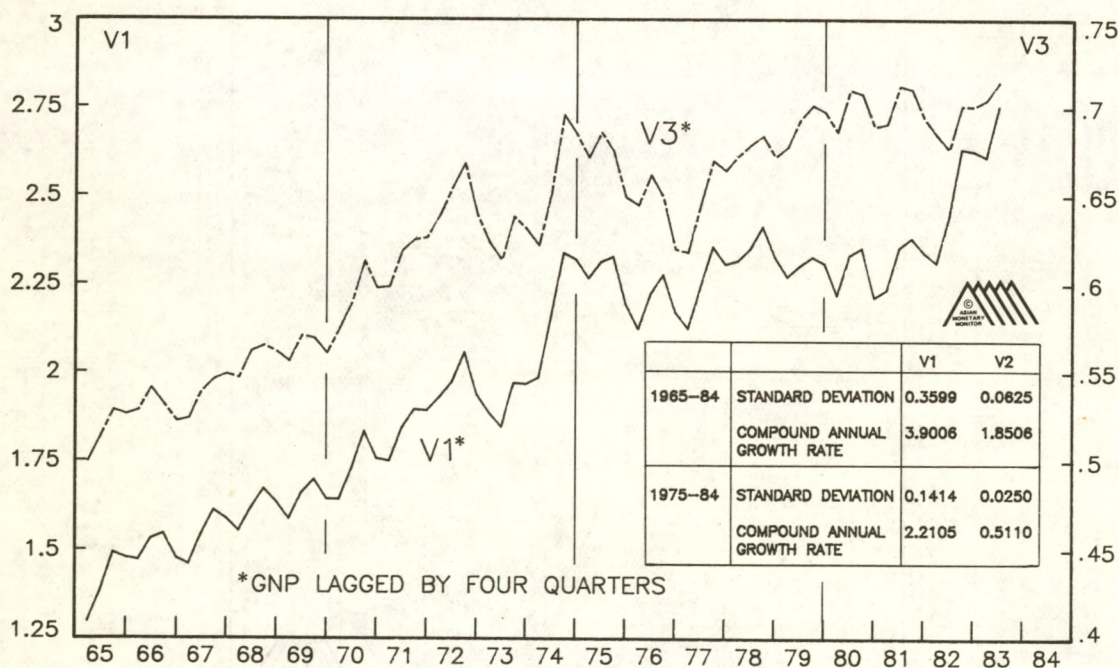
AUSTRALIA: CHART 3 THE MONETARY MULTIPLIER (M3)



AUSTRALIA: CHART 4 THE VELOCITY OF CIRCULATION



AUSTRALIA: CHART 5 THE VELOCITY OF CIRCULATION



Therefore, in this article we have estimated the monetary multipliers for M1 and M3 using the narrow definition of the monetary base. The trends in the monetary multiplier for M1 and M3, illustrated in Charts 2 and 3 suggest that from the standpoint of official control over the two monetary aggregates, M3 is the more appropriate for use as a monetary target. To the extent that the Reserve Bank is willing and able - either directly or indirectly - to control the growth of the monetary base a comparison of Charts 2 and 3 suggests that it will be more able to determine growth in M3 than growth in M1. Whereas the M3 monetary multiplier has been comparatively stable, especially since 1977, the M1 multiplier has proved volatile. The greater stability in the M3 multiplier compared with the M1 multiplier since 1981 is particularly relevant because there have been no adjustments to statutory reserve requirements since January of that year. Thus the sizeable decline in the M1 multiplier since then cannot be accounted for by changes in the Statutory Reserve Deposit ratio. Prior changes in the level of the M1 and M3 multipliers were often partly associated with adjustments in the SRD ratio. For example, the rise and subsequent decline in the unadjusted (for changes in reserve requirements) monetary multiplier in the 1974-1977 period coincided with a decline in the SRD ratio from 9% in 1974 to 3% at the end of 1975 followed by an irregular increase in the SRD ratio to 10% in 1977.

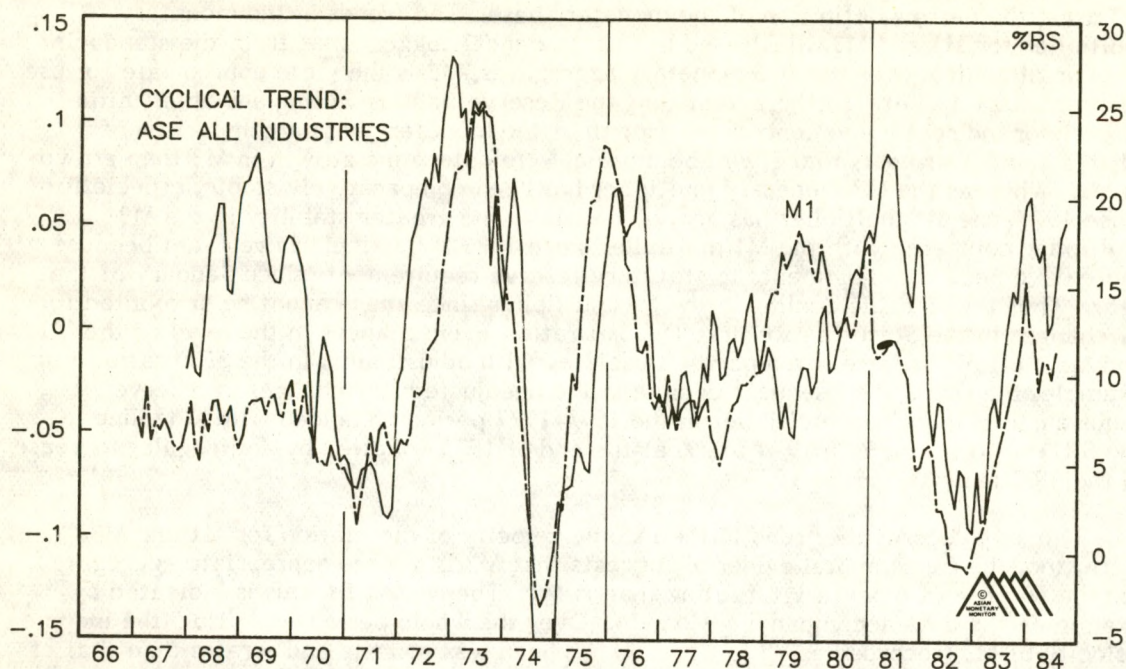
Chart 4 records the trend in the income velocity of circulation for M1 and M3. Here, too, the fundamental evidence suggests that M3 is a more appropriate aggregate for the purpose of monetary targeting than is M1. The reason for this is indicated by examining the data accompanying Chart 4. Over the whole period since 1965 the income velocity of M3 (recorded as V3 in Chart 4) has been less volatile and erratic than that of M1. Using the standard deviation of the trend of V3 as a measure of its volatility we find that V3 is less volatile than V1 over both the 1965-1984 period and for the period 1975-1984.

Chart 5 attempts to assess the trend in the income velocity of M1 and M3 in a slightly different manner. Monetary theory suggests that changes in monetary growth have impact growth in nominal GNP with a lag. Thus in Chart 5 we have recorded the ratio between the two monetary aggregates and nominal GNP four quarters later. The choice of a four quarter lag is admittedly arbitrary but represents an acknowledgement that changes in the level of the money supply are not expected to lead to immediate changes in the level of nominal income. These estimates of the lagged income velocity of M1 and M3 again indicate that M3 may be a more appropriate aggregate for use as a monetary target. The reduced volatility of the lagged V3 estimate compared with our lagged V1 estimate is an indication that changes in the level of M3 are typically more closely related to changes in the level of nominal GNP than are changes in the level of M1.

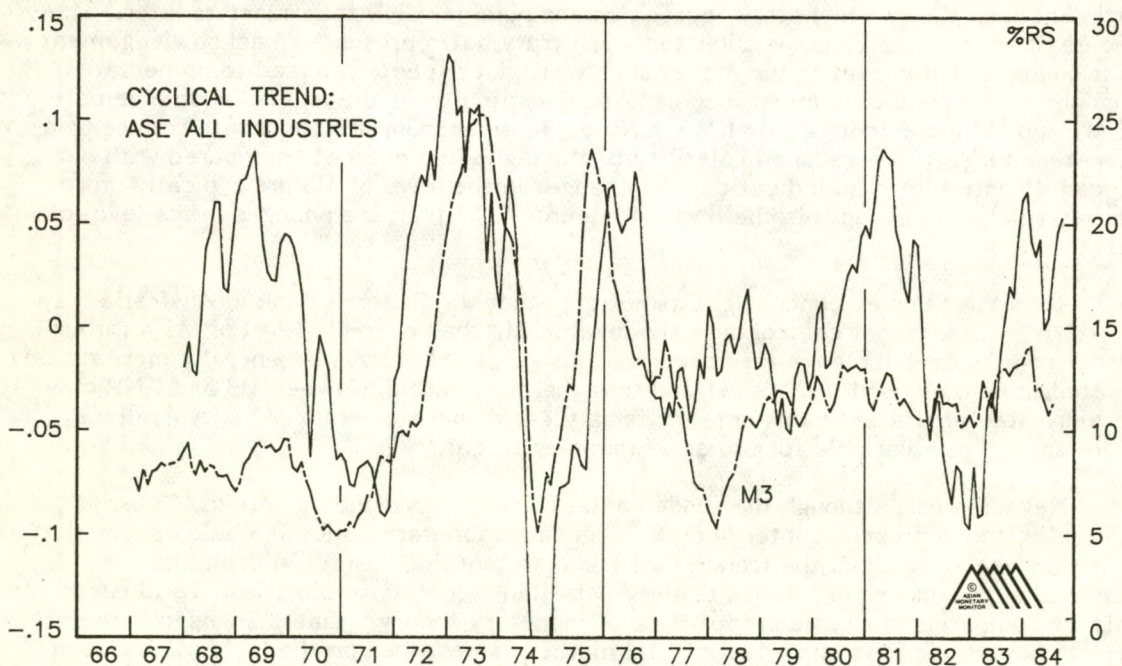
Thus the basic evidence suggests not only that the Reserve Bank in Australia may exercise greater direct control over the level of M3 than over the level of M1 - through direct control over the monetary base - but also that M3 growth is generally more closely related to nominal GNP than is M1 and that the relationship between M3 and GNP may be more stable. These fundamental criteria suggest therefore that M3 is typically a more appropriate variable for use as a monetary target.

Nevertheless, although the fundamental economic evidence points to M3 as, generally, the appropriate intermediate target for monetary policy it would appear that in recent years, at least, the trend in M1 has also contained useful information concerning the underlying stance of the Australian monetary authorities. To illustrate this we compare some basic propositions of monetary theory - that changes in monetary growth have their first impact on capital market values, then on the level of output in the economy and finally upon the level of inflation - with actual developments in the Australian economy.

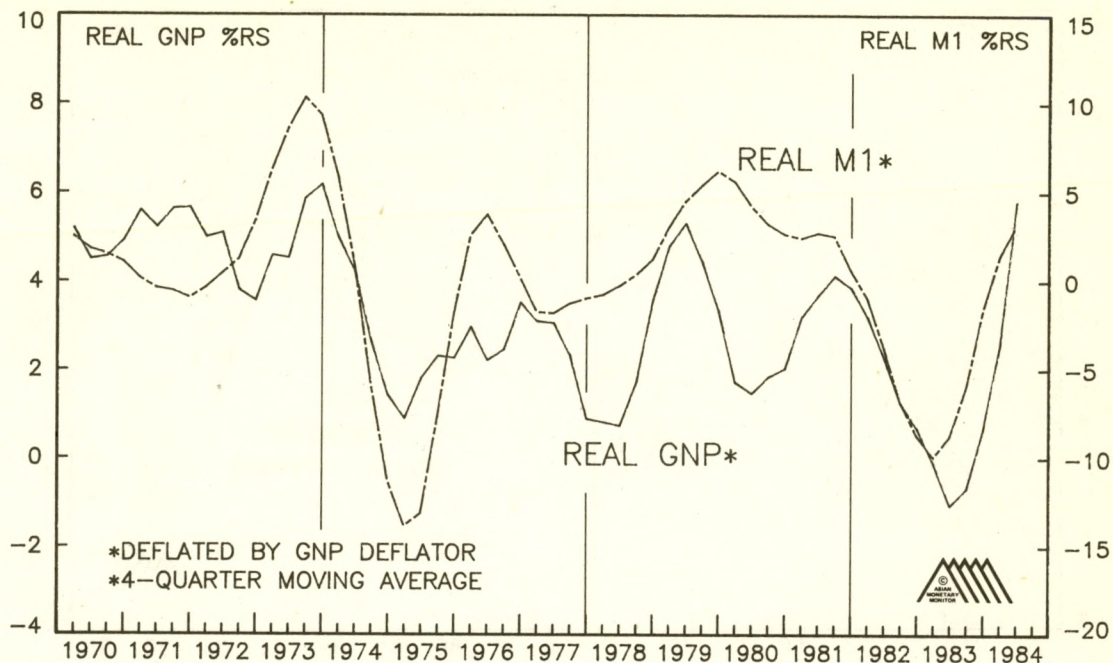
AUSTRALIA: CHART 6
MONETARY GROWTH (M1) AND THE CYCLICAL TREND IN THE STOCKMARKET



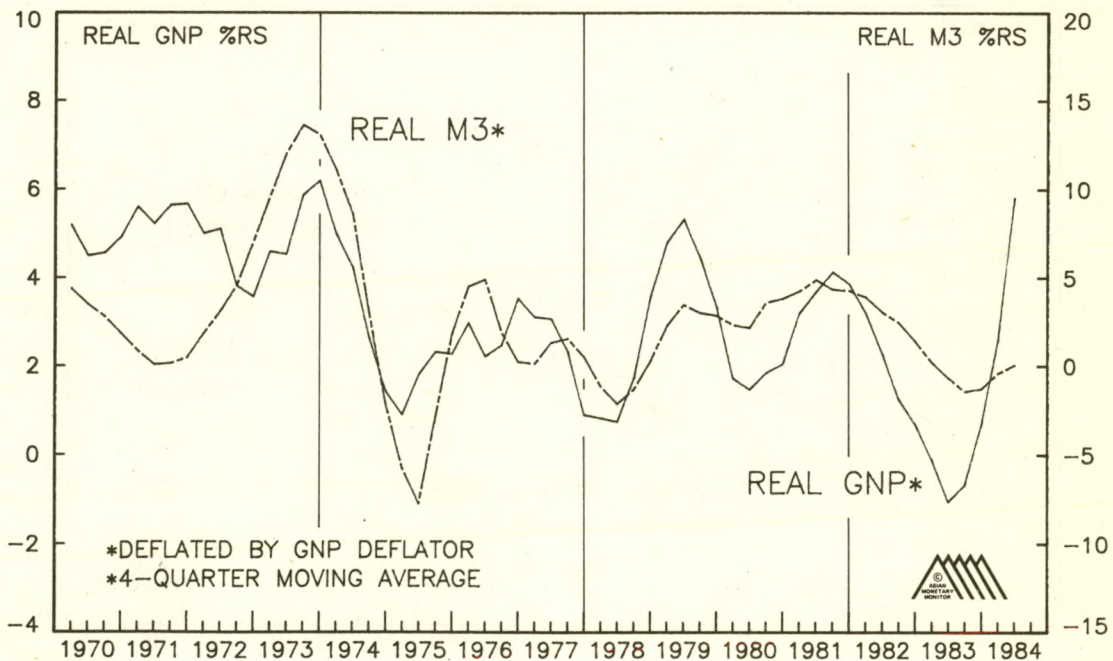
AUSTRALIA: CHART 7
MONETARY GROWTH (M3) AND THE CYCLICAL TREND IN THE STOCKMARKET



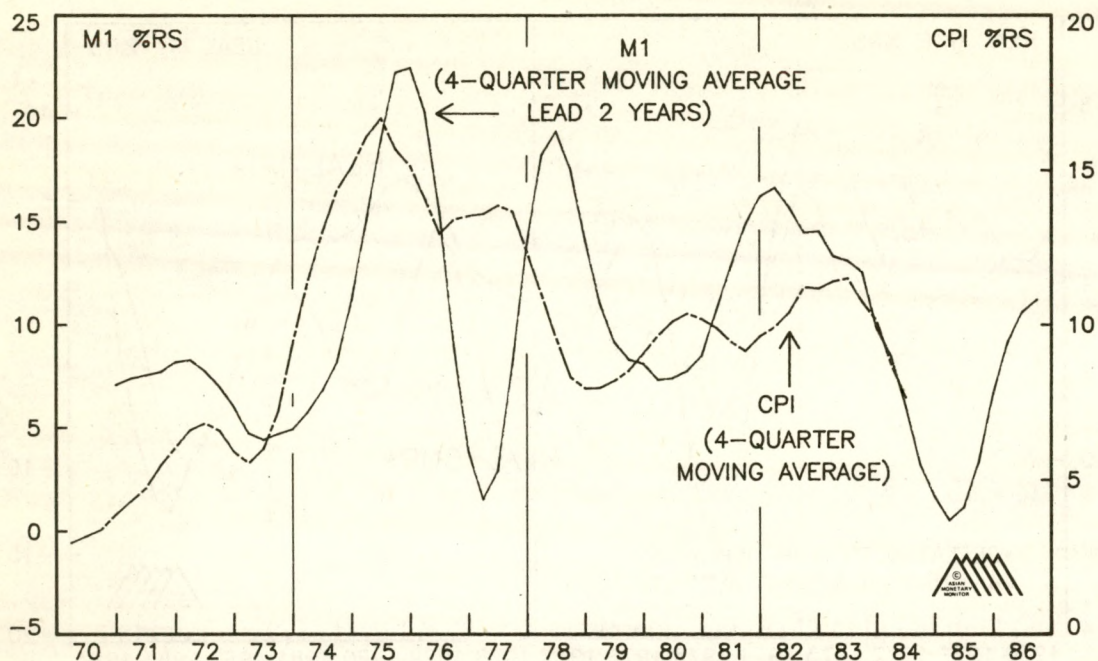
AUSTRALIA: CHART 8
REAL MONEY GROWTH (M1) AND REAL GNP GROWTH



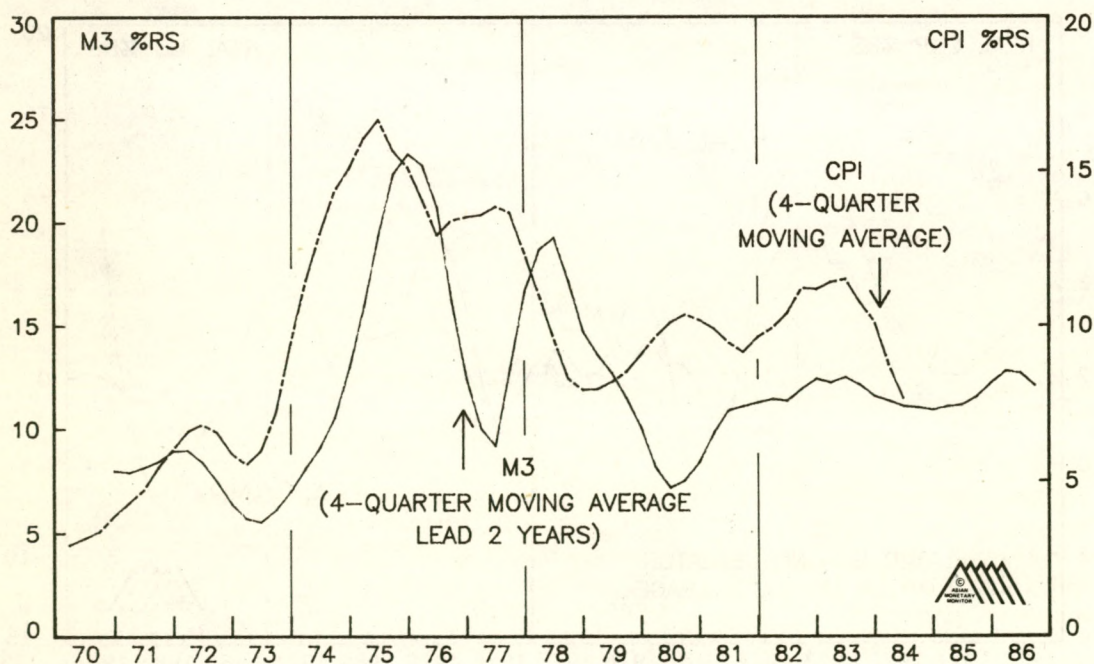
AUSTRALIA: CHART 9
REAL MONEY GROWTH (M3) AND REAL GNP GROWTH



AUSTRALIA: CHART 10
THE LINKAGE BETWEEN MONEY (M1) AND INFLATION



AUSTRALIA: CHART 11
THE LINKAGE BETWEEN MONEY (M3) AND INFLATION



Charts 6 and 7 compare the year-to-year rate of change in the money supply with a measure of the cyclical trend* in the A.S.E. All Industries Stock Market Index.

It is evident that monetary growth is often a useful guide to changes in the level of industrial stockmarket values in Australia. However in the period surrounding the recent recession in Australia it is clear that M1 growth proved superior to M3 as an indicator of stockmarket performance. To the extent that capital market values reflect changes in monetary policy, the weakness in industrial stock prices during 1981 and 1982 and their subsequent firm recovery suggests that M1 behaved as an important indicator of the Reserve Bank's effective monetary policy.

The recent trend in both in real GNP growth and in inflation suggests a similar conclusion. The sharp downturn both real (Chart 8) and nominal M1 growth appear to be more consistent with the environment preceding Australia's most serious recession since the war, and with the subsequent decline in inflation than does the steady growth in M3.

FORECAST: The basic evidence presented here suggests that it is appropriate that the Reserve Bank places emphasis upon M3 as its principal intermediate target. The Reserve Bank may exercise greater direct control over the level of M3, through control over the monetary base, than it may over M1, and the income velocity of M3 is comparatively stable.

Nevertheless, M1 remains an important monetary indicator: M1 has signalled more accurately the composition of nominal GNP growth in recent years. That is to say, the trend in M1 foreshadowed more accurately the breakdown of nominal GNP into its real and nominal components. It is of interest to note that both M1 growth and M3 growth have now converged and - if current growth rates are sustained for a further one or two quarters - that both aggregates now provide similar indications for the future trend in nominal GNP. On the basis of the past trend in velocity growth and the present trend in monetary growth investors may anticipate an increase in nominal GDP in the order of 12%-15% over the next year. In addition both M1 and M3 indicators suggest that the nominal, or inflationary, component of this increase in GNP may rise during 1985.

* All time series may be thought of as having both a secular and a cyclical trend. It is reasonable to think that the secular trend a stockmarket index will represent the earnings growth of the companies comprising the index. The cyclical trend in the index, however, may reflect changes in key macro-economic variables such as monetary growth, interest rates, inflation etc.

SOURCES OF THE IMPROVED TRADE PERFORMANCE

Hong Kong's trade performance has shown a dramatic improvement since the start of the American economic recovery in early 1983. The trade accounts have even shifted from their traditional deficits to actual surpluses in some months. For example in July total exports of HK\$20.137 billion exceeded imports of HK\$19.816 billion, giving a visible trade surplus of HK\$321 million. The July surplus was the first one in July since 1976. For the period January-July the cumulative value of exports for the seven months was HK\$120.009 billion against imports of HK\$125.370 billion, giving a cumulative deficit of HK\$5.361 billion - approximately half the size of the visible trade deficit over the same period in 1983, and only 2.2% of the value of total trade compared with 5.5% of the value of total trade over the same period in 1983.

There are four main sources of this upswing in Hong Kong's export performance. First is the US economic recovery and the boom in exports to the USA. Second is the growing volume of re-exports from China through Hong Kong. Third is the continuing benefit derived from the relative undervaluation of the Hong Kong dollar at the time of the fixing of the official parity at HK\$7.80 per US dollar in October 1983. And fourth is the boost that has been given to exports from the restructuring effect of changes in the balance of payments resulting from capital outflows. The contribution of these four sources will be described in the subsequent sections of this article.

(a) The Boom in Domestic Exports to the USA

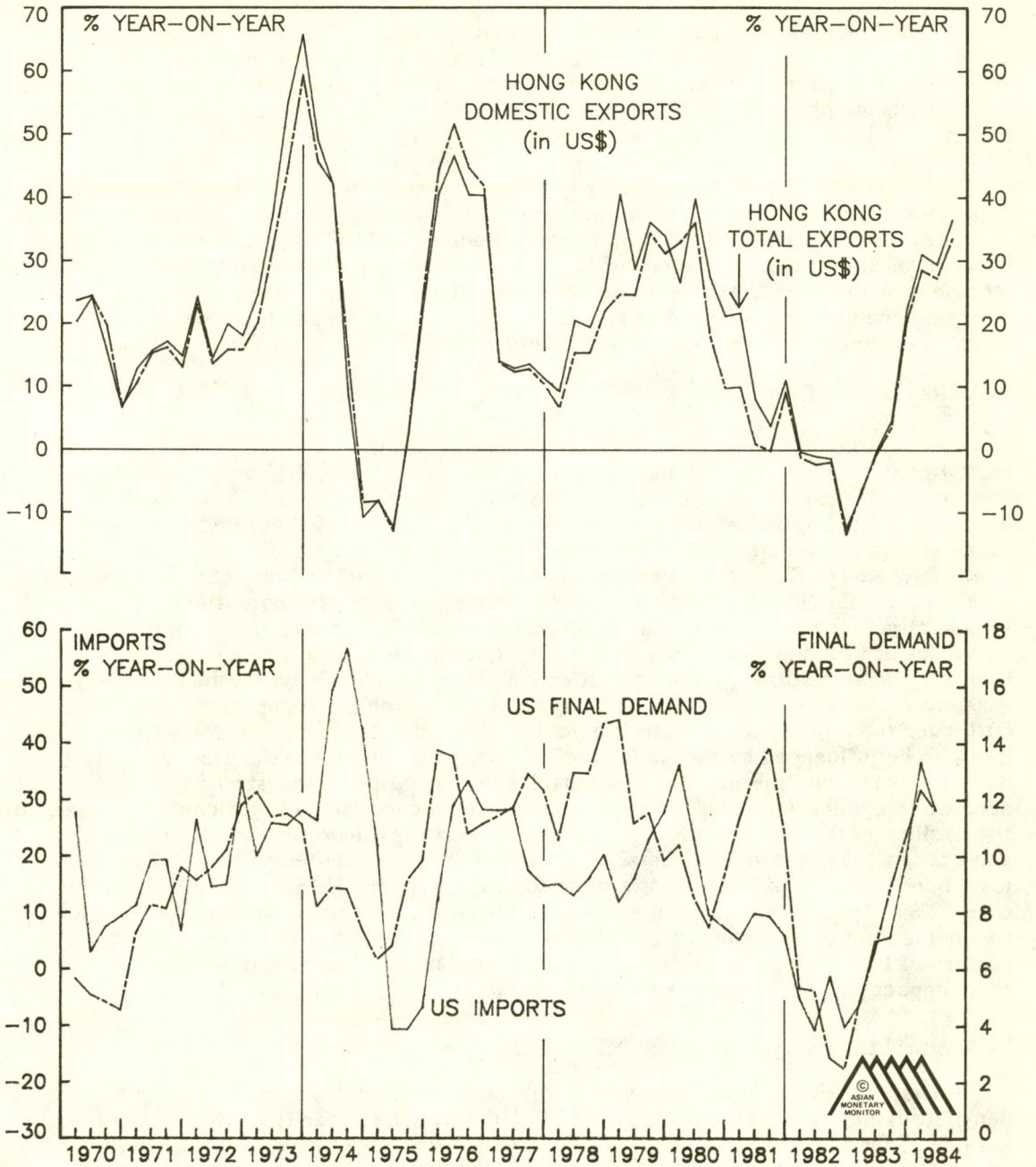
Chart 1 shows the relationship between Hong Kong's exports, US imports, and US domestic final demand (all in US\$ terms) over the past fourteen years. In the 1971-73 boom there is a clear link between upswing in the USA and the upturn in Hong Kong's exports, as one would expect, with the US accounting for 38.5% of Hong Kong's domestic exports in those years. However the peak in Hong Kong's export growth occurred in the fourth quarter of 1973 (59.3% on a year-to-year basis) whereas the peak in US import growth did not occur until the third quarter of 1974 (at 56.7%). This is largely due to the impact of the OPEC oil price hike from the end of 1973 which curtailed the growth of exports from Hong Kong and led to a massive increase in US imports in the succeeding three quarters.

Following the 1974 recession the recovery in Hong Kong's exports in 1975 was virtually coincident with the US economic recovery in the same year, with the year-to-year figures showing a sharp rise from the third quarter of 1975. Hong Kong's recovery was export-led, with export growth peaking in the second quarter of 1976. In 1977 and 1978 leadership shifted to the domestic sector as domestic demand began to grow more rapidly than overseas demand for Hong Kong's exports. The slowdown in Hong Kong's export growth paralleled the slowdown in economic growth in Japan, West Germany and other European economies, but as Chart 1 shows, nominal GNP growth in the USA continued quite strongly through 1976-1978.

In 1979-80 Hong Kong's exports experienced a renewed surge, again outpacing domestic demand factors, even though the Hong Kong economy was by this time exhibiting clear symptoms of overheating. This secondary upswing in Hong Kong's exports during what was basically an extension of the same global business cycle coincided with the strong rise in commodity prices that is normally associated with the late stages of a business cycle expansion, the commodity price rise being reinforced by the further raising of oil prices by the OPEC cartel, the so-called second oil shock. The level of economic activity in many of Hong Kong's major trading partners had risen substantially - e.g. Japan and Germany had fully recovered from their mini-recessions of 1977 - and so global demand for Hong Kong's exports was strong.

HONG KONG: CHART 1

HONG KONG EXPORTS, US IMPORTS AND US FINAL DEMAND



At this point, from mid-1980 onwards until September-October 1983, the Hong Kong dollar began to weaken quite seriously against the US dollar and it is therefore advisable to look at Hong Kong's export performance by converting HK\$ figures into US\$ (as done in Chart 1). In local currency terms Hong Kong's exports continued to behave extremely well despite the fact that the world was moving into recession in 1981-82. However, as is clear from our US\$-based chart Hong Kong's exports slumped pretty much in line with the behaviour of US imports in 1981-82, with only a slight blip upwards at the end of 1981 in response to the short-lived recovery in the US of 1980-81.

The cyclical record since the early 1970's makes it clear that Hong Kong's current export-led recovery is very typical in pattern - comparable with the business cycle upswings of 1971-73 and 1975-76, the comparison with 1975-76 being the more apposite in terms of amplitude. However, aside from the demand-pull exerted by high nominal income growth in the USA, there are additional elements in the current upswing which may well enable Hong Kong's export-led boom to continue longer than the two years which the economy experienced in 1975 and 1976.

(b) Re-exports from China

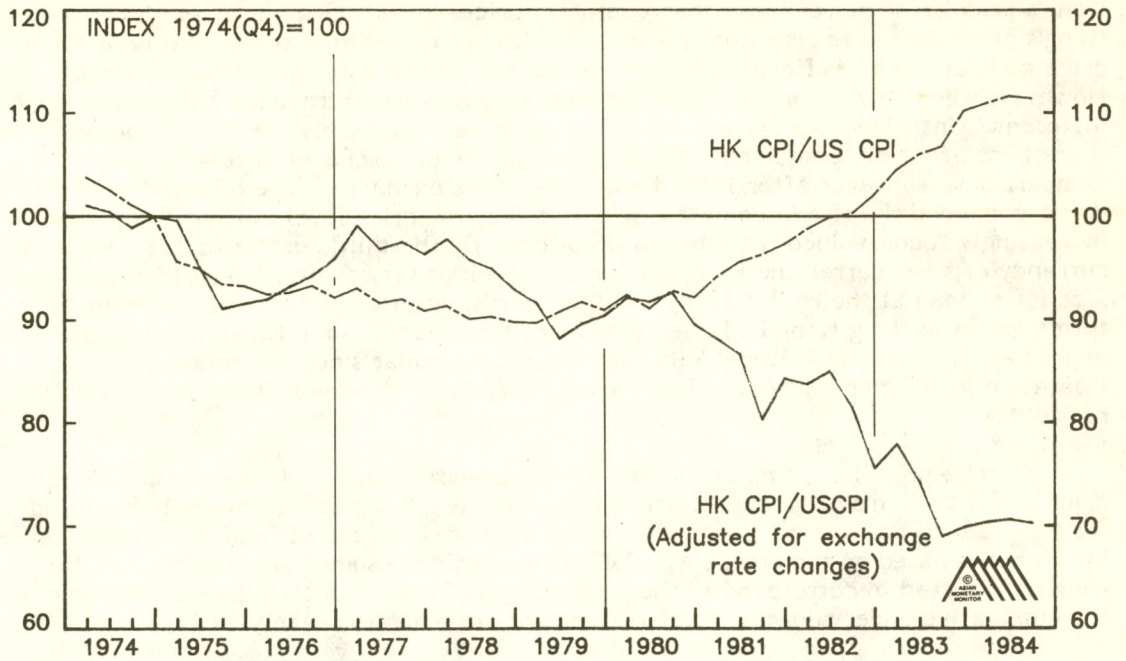
Hong Kong's trade with China has mushroomed in the past five years. Since 1979 Hong Kong's imports from China have grown from HK\$15 bn (US\$3 bn. at prevailing exchange rates) to over HK\$50 billion (US\$6.4 bn. at HK\$7.80 per US\$) in the year to June 1984, doubling in US\$ terms. A substantial proportion of these imports are semi-fabricated goods which are finished or packaged in Hong Kong and re-exported abroad from Hong Kong. Re-exports accounted for almost one half of Hong Kong's imports of goods from China in the year to June 1984. Because the growth potential of the People's Republic of China is so great and because so much of the exports of the southern provinces of China are funnelled through Hong Kong, there is a leveraged effect on Hong Kong's trade statistics. Assuming that economic policies in China are further liberalised it seems reasonable to expect Hong Kong to become even more important as an export outlet for the hinterland of South China. However, the demand for exports from China is likely to be influenced by the same kinds of factors which affect the growth of Hong Kong's exports, and therefore it is doubtful whether, despite their strong secular (as opposed to cyclical) upswing, re-exports from China can make a significant difference to the cyclical pattern of Hong Kong's exports, though they may raise the level of total exports. In 1983 re-exports from China via Hong Kong amounted to HK\$19.7 billion, or just under one fifth of Hong Kong's total domestic exports (HK\$104.4 billion), and just over 12% of Hong Kong's total merchandise trade. It is doubtful whether, on their own, the momentum of re-exports from China can materially affect the overall growth pattern of Hong Kong's exports during this cycle, but the direction is favourable, and their impact will be growing in the years ahead.

(c) Undervaluation of the Hong Kong Dollar

When the Hong Kong dollar was stabilised in October 1983 by the linking of HK\$ banknote issues and redemptions to the US dollar at a fixed parity of HK\$7.80 per US\$, it is fairly clear that the Hong Kong dollar was undervalued relative to the US dollar at the new official parity. That is, given the levels of domestic prices in Hong Kong and the USA at the time of the Hong Kong dollar stabilisation package, setting the price of the US\$ at HK\$7.80 gave Hong Kong's exporters an exceptional price advantage when compared with their competitors in US\$ terms. In other words, if Hong Kong's domestic prices were to be translated into US\$, the price level in Hong Kong as judged by a potential US purchaser would have been much lower at the end of October 1983 than at the beginning of September before the currency crisis.

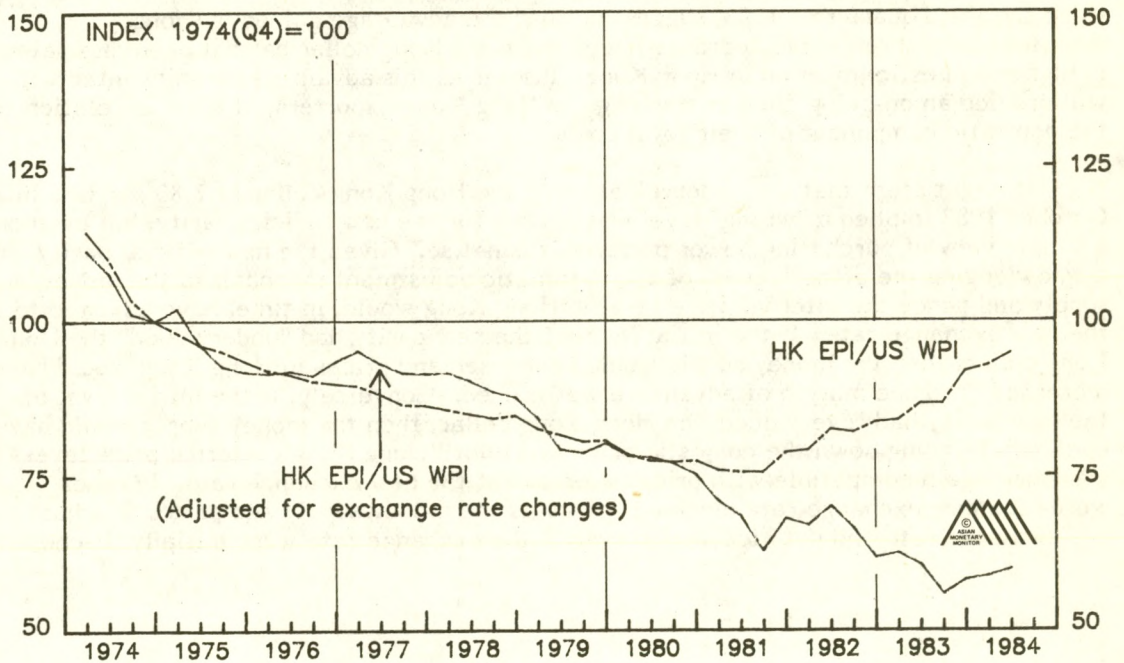
HONG KONG: CHART 2

RELATIVE CONSUMER PRICE LEVELS IN HONG KONG AND U.S.



HONG KONG: CHART 3

HONG KONG EXPORT PRICES AND US WHOLESALE PRICES



The evidence for this is presented in Charts 2 and 3. Chart 2 compares the level of consumer prices in Hong Kong and the USA from the time of the floating of the Hong Kong dollar in November 1974 (the dashed line). During the period up to 1979 Hong Kong's prices rose more slowly than consumer prices in the USA, but after 1980 Hong Kong's prices began to rise more rapidly than US prices with the result that on a simple price comparison basis Hong Kong's prices had risen some 10% more than US prices. However, when changes in the HK\$/US\$ exchange rate are introduced the story is very different. Until 1980 the Hong Kong dollar remained reasonably stable and consequently there is no great difference between the unadjusted and exchange rate-adjusted comparisons. However after 1980 the decline in the exchange value of the Hong Kong dollar exceeded the rise in domestic prices so that the price level in Hong Kong was increasingly "undervalued" relative to US prices. By the third quarter of 1983 when the currency crisis occurred the Hong Kong price level, as viewed by a US resident, was some 30% lower than at the end of 1974. In other words, despite the fact that in domestic terms prices in Hong Kong had risen 10% more than prices in the USA, a cumulative 40% depreciation of the Hong Kong dollar against the US dollar since the time of its floatation in November 1974 made prices in Hong Kong now seem 30% cheaper for US residents.

Chart 3 provides a similar measure of the apparent undervaluation of the Hong Kong dollar in terms of an export price index for Hong Kong and a wholesale price index for the USA. (The export price index for Hong Kong is not the official export unit value index, but is based on the components of the domestic consumer price index with the weights adjusted to correspond to the composition of Hong Kong's exports.) In this case the cumulative undervaluation appears even greater - approximately 40%.

Purchasing power comparisons of this kind are subject to considerable margins of error due to wide discrepancies in terms of the goods included in the price indices, shifts in the composition of trade, and assumptions about the validity of the base date. However, even taking such factors into account it seems abundantly clear that the overall consumer price level in Hong Kong, as viewed from the standpoint of a US resident declined markedly in 1981-83, giving Hong Kong producers a significant comparative advantage in world markets. There has not been much relative price change since the third quarter of 1983, suggesting that the advantage gained by Hong Kong manufacturers through the depreciation of the Hong Kong dollar has not been dissipated in higher domestic inflation in Hong Kong. Insofar as this advantage remains intact, it will provide an on-going competitive edge to Hong Kong exporters, at least in relation to the domestic component of their total costs.

It might seem that the undervaluation of the Hong Kong dollar at 7.80 per US\$ in October 1983 implied a "wrong" level was chosen for the new official parity, but even on a simple view of purchasing power parity this is not so. Given the new official parity and acknowledging the effectiveness of the automatic adjustment mechanism, the money supply and hence the internal price level in Hong Kong would, in time, have adjusted to the new exchange rate. If the initial level of the new parity had "undervalued" the Hong Kong dollar, then the money supply would have risen and prices in Hong Kong would have increased until the margin of advantage was eroded. Conversely, if the initial level of the new parity had "overvalued" the Hong Kong dollar, then the money supply would have declined, bringing down the domestic price level until Hong Kong's internal price level was once again compatible with prices overseas at the new exchange rate. In other words the new exchange rate mechanism causes the money supply and prices to adjust to the exchange rate and not vice-versa, even if the exchange rate were initially ill-chosen.

HONG KONG'S OVERALL BALANCE OF PAYMENTS

(HK\$ billion)	<u>1982</u>	<u>1983</u>	<u>1984</u> (Est.)	
Domestic Exports and Re-Exports	127.4	160.7	225	(+40%)
Imports	-142.9	-175.4	-237	(+35%)
VISIBLE TRADE BALANCE	-15.5	-14.7	-12	
Exports of Services	30.1	35.1	+49	(+40%)
Imports of Services	-20.8	-24.7	-33	(+35%)
(SERVICES BALANCE)	(+9.3)	(+10.4)	(+16)	
BALANCE OF GOODS AND SERVICES	-6.2	-4.3	+4	
NET CAPITAL BALANCE	+6.2	+4.3	-4	
OVERALL BALANCE	0	0	0	

Notes

- (1) Presentation. The balance of payments statistics of a country provide "a systematic record of all the economic transactions during a given period between its residents and residents of the rest of the world." Since data for Hong Kong do not distinguish between resident and non-resident persons or entities, the available data must be considered only as an approximation.
All transactions have a physical component (e.g. shipment of goods for sale overseas, or acquisition of a security) and a financial or monetary component (e.g. receipt or payment in domestic or foreign currency). Transactions appear simultaneously as a credit and debit, with total credits and total debits in balance: Trade Balance + Services + Transfers + Capital (Long-term Capital, Short-term Capital, Balance of Monetary Movements) = 0
- (2) In this table it is assumed that Exports and Imports of Services show the same growth rates in 1984 as Exports and Imports of Goods respectively. Various refinements could be attempted, but the inadequacies of the data mean that only approximate orders of magnitude can be calculated. Receipts and payments of interest, dividends etc. are not included in Exports and Imports of Services shown here.
- (3) Net official financing figures for Hong Kong are not available, and banking data do not distinguish between claims on or liabilities to residents and non-residents. Accordingly the residual balancing item is designated Net Capital Balance, and includes Transfers, Short-term Capital, Long-term Capital, and Net Monetary Movements:
Visible Trade Balance + Services + Net Capital Balance = Overall Balance = 0
(Net Monetary Movements equals changes in external assets of the government plus changes in assets and liabilities of residents and non-residents with the banking sector.)

However, the argument here only considers one component of the overall balance of payments, namely the balance of transactions in goods and services, whereas the overall balance of payments includes capital movements as well as the balance on trade account. To obtain a broader picture of the complete adjustment process the next section will extend the analysis to consider the impact of capital movements in the overall adjustment process.

(d) Structural Adjustments in the Overall Balance of Payments

The analysis of purchasing power parity in the preceding paragraphs applies to the comparison of the prices of goods and services in different countries and the appropriate exchange rate or domestic price levels for transactions between the two countries. However, transactions between countries are by no means restricted to trade in goods and services; transactions in financial assets i.e. capital movements may be - and in recent years have become - far more significant in the overall balance of payments. (In addition transfers of capital or goods in the form of gifts or aid may occur in substantial volume without reference to relative prices in the two countries, but we shall not consider the impact of such transfers in this article.)

In Hong Kong the political and financial history of the past two years has been such as to precipitate what we believe to be a major change in the pattern of capital movements. Historically Hong Kong typically ran a deficit on its merchandise trade account, and a smaller surplus on its trade in services, leaving a deficit on the net balance of goods and services, counterbalanced by a surplus on the combined capital and other 'invisibles' accounts. Uncertainty over the long term future of Hong Kong, and in particular a decline in the perceived returns on capital assets in Hong Kong has led to a movement of capital out of the territory, so that instead of a trade deficit (in goods and services) balanced by a capital inflow, we estimate that it is possible that the overall balance of payments has shifted to a capital outflow balanced by a surplus on trade in goods and services - assuming the overall balance of payments to be balanced at the fixed exchange rate. The rough estimates for 1984 in the table on p.17 give an approximate indication of the extent of this reversal in Hong Kong's traditional balance on capital account. From an implicit capital inflow of some HK\$4 billion in 1983 the capital accounts may show a deficit of up to HK\$4 billion in 1984, a net deterioration of some HK\$8 billion.

Much attention has been focussed on the improvement of Hong Kong's trade performance in the past few months, but it is clear from the argument above that the improvement in the trade account is the direct counterpart of the deterioration in the capital account - they are two sides of the same coin. In order to finance the acquisition of capital assets abroad, Hong Kong residents have had to sell more goods and services to non-residents. The role of the "undervaluation" of the Hong Kong dollar at HK\$7.80 now becomes much clearer: by providing Hong Kong's exporters - or sellers of goods and services - with an artificial advantage the new parity has helped to achieve a significantly better performance on trade account than could otherwise have been expected, and in so doing it has enabled Hong Kong residents to finance the purchase of capital assets abroad with the proceeds. Of course it may not be the same individuals that export goods and services who also acquire assets overseas, but the overall balance of international payments requires that in an aggregate sense an equilibrium is attained between exporters and importers on trade account and exporters and importers of capital.

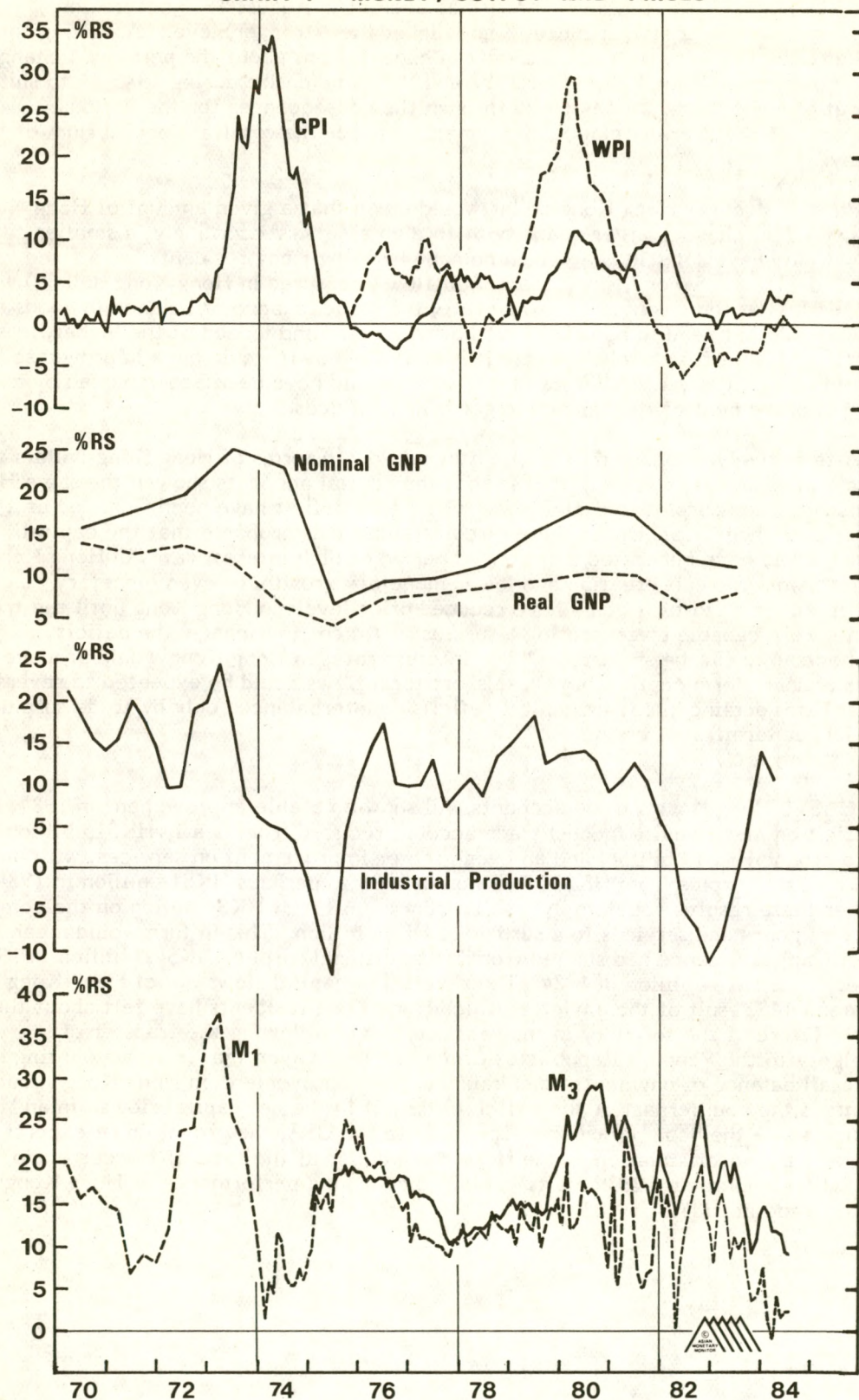
It is useful to enquire what might have happened if the exchange rate had been set at HK\$7.00 per US\$ (i.e. the level that it had been at in August 1983 before the September currency crisis), or indeed some higher (i.e. stronger) level. Assuming that there had been the same autonomous shift in expectations about the perceived changes in returns on assets in Hong Kong after 1997 and the same desire during 1983-84 to shift funds out of Hong Kong, we can trace through the consequences for the various components of the overall balance of payments and for the resultant equilibrium of the economy.

First, a stronger Hong Kong dollar would mean that a given amount of Hong Kong dollars could purchase a larger quantity of foreign assets. Accordingly, a smaller capital outflow would have satisfied any given demand by Hong Kong residents for a fixed value of assets overseas. Second, since the net outflow (measured in Hong Kong dollars) would have been less at the stronger exchange rate, the trade balance or balance in goods and services would not need to have improved by as much - and indeed at the higher, less competitive level of the exchange rate it is unlikely that it would have improved so much. In other words, a smaller capital outflow would have been accompanied by a smaller improvement of the balance in goods and services.

Alternatively, suppose that the capital outflow in terms of Hong Kong dollars were the same at HK\$7.00 as at HK\$7.80, so that the capital accounts showed the same HK\$8 billion swing from surplus to deficit, how would that deficit have been financed at a stronger exchange rate? Under these circumstances it is probable that the capital outflows would have generated a prolonged period of high interest rates in Hong Kong, leading to slower credit creation and lower monetary growth, or even monetary contraction, which in turn would have reduced price levels in Hong Kong until the trade accounts were capable of generating a surplus sufficient to 'finance' the deficit on capital account. (In the short term 'high' interest rates in Hong Kong would produce inflows of short term capital, but these short term flows could be expected to reverse as interest rates declined, leaving capital deficits counterbalanced only by trade surpluses in the longer term.)

FORECAST: Hong Kong's trade accounts will show a notable improvement in 1984, with the deficit on merchandise (goods) trade account reduced from nearly HK\$15 billion in 1983 to around HK\$12 billion, and an even greater improvement on services, with an increase in the surplus from HK\$10.4 billion in 1983 to perhaps HK\$16 billion in 1984. Together these results would imply a shift from a deficit of HK\$4 billion on the combined balance of goods and services to a surplus of HK\$4 billion. This in turn would mean that the Net Capital Balance had shifted from its traditional surplus (HK\$4.3 billion in 1983) to a deficit of HK\$4 billion in 1984. The reversal in capital flows out of Hong Kong is an understandable result of the anxieties which Hong Kong residents have felt about the political future of the territory in the years up to and following the transfer of sovereignty to the People's Republic of China in 1997. Given that in an accounting sense the overall balance of payments must balance, the improvement on Hong Kong's trade accounts is the counterpart of the switch to deficit in the net capital flows. In an economic sense the boom in exports especially to the USA, the growth in re-exports from China, and the undervaluation of the Hong Kong dollar at the time of the currency stabilisation in October 1983 help to explain the striking performance of Hong Kong's external trade in 1984.

SINGAPORE
CHART 1 : MONEY, OUTPUT AND PRICES



THE PUBLIC SECTOR'S IMPACT UPON LIQUIDITY

The Singapore economy grew very strongly during the first half of this year, at a rate close to 10%, and the economic growth rate for the full year is widely expected to be as high as 9%. However, money growth has remained persistently low and the end-1983 recovery in liquidity referred to in our last AMM article on Singapore (AMM Vol. 8 No. 1) has proved to have been very short lived. Between January and June of this year M2 registered practically no growth and M1 actually declined sharply. Consequently by June the year-on-year growth rate of M2 had been reduced to 8.7% from 12.7% in January, and the annual growth rate of M1 had fallen to 2.3%.

In past issues of AMM we have frequently emphasised that because the Singapore Monetary Authorities operate a managed exchange rate regime the balance of payments position will necessarily be the major determinant of the behaviour of the money supply. Indeed past AMM studies have indicated a very good correlation between certain components of the balance of payments, the exchange rate and the growth of the money supply which give empirical support to this notion. However, the growing contractionary influence of the government sector, which has an important influence on the long-run trend of money growth, cannot be ignored. Indeed it may be particularly relevant now because as a recent article on Singapore (AMM Vol. 8 No. 1) explained, the low rate of money growth last year was, in a numerical sense, the result of the negative impact of the government sector on the monetary base (in a numerical sense because, in theory, the monetary authority can always offset this influence if it chooses to do so).

The same AMM article also explained that a lack of compatibility between the published statistics makes it difficult to form a complete understanding of the government sector's influence on the money supply. However, from what is available it is possible to build up a fairly complete picture of government sector operations on an annual basis, and various relevant data series are available on a monthly basis. The purpose of this study is to attempt to piece together all the available data with a view to determining the extent to which the current low rate of money growth can be attributed to government sector operations and how those operations are likely to affect the future course of money growth in Singapore.

At first sight the monetary impact of the government's fiscal operations appears to be stimulatory, as the announced government budget has been in growing deficit over recent years. (The budget for 1984 projects a deficit of S\$3.92 bn, following a S\$2.76 bn deficit in 1983.) However, the budget deficit is more illusory than real because the budget relates primarily to the Central Government and yet includes as expenditures loans to the statutory boards, while not including the revenues of those boards. The largest of the statutory boards, the Housing and Development Board (HDB), has incurred large deficits over the past two years as it has undertaken its massive public housing project. Last year, for instance, the Central Government lent HDB roughly S\$3.5 bn, a sum which was included in the budget as Central Government expenditure. The budget does not include revenues of the HDB, which will pick up as the housing units are sold.

The Ministry of Trade and Industry publish a consolidation of public sector revenue and expenditure in their annual 'Economic Survey'. The figures in this table cannot be reconciled with the budget figures as they are calculated on a calendar, rather than fiscal, year basis. However, because they consolidate out transfers of funds between the Central Government and statutory boards they give a more accurate, if not perfect,

monetary picture. The picture is not perfect because contributions to the sinking fund (effectively money set aside for future debt service payments) are included in the figures as a government expenditure. Such transfers of funds between different government accounts do not lead to a decrease in government net claims on the banking sector at the time they are made and hence by themselves have no monetary implications. Thus, in our estimates of the government sector's contractionary impact we have added contributions to the sinking fund back in; these estimates are presented in Table 1.

The most important single influence on the money supply stemming from the operations of the authorities is that of the forced savings scheme - the Central Provident Fund. The contractionary effect of the CPF (measured by the net inflow into the Fund) has grown sharply over recent years as the economy has grown and contribution rates and contribution ceiling levels have been successively raised. The CPF maintains the bulk of its balances at the MAS as 'advance deposits' which are converted into government bonds when they are issued. Hence, in Table 1, the contractionary impact of the CPF is represented as the 'CPF Net Inflow', while the 'Increase in other Domestically Held Government Debt' represents the total of domestic government bond and treasury bill issues which are not taken up by the CPF.

The sum of the announced public sector surplus with the contribution to the sinking fund, the CPF net inflow, and government bond sales to domestic institutions other than the CPF gives the total monetary flow from the private sector to the public sector (i.e. Central government, the Statutory Boards and the CPF) and, in a sense, represents the potential contractionary impact of the authorities on the monetary base. It would only be the actual contractionary effect, however, if the government sector kept all its balances at the MAS. In fact this is not the case and the government sector (probably the statutory boards in particular) keeps large deposits with the commercial banks. These have grown rapidly over recent years, perhaps because of monetary policy considerations. The total of government sector deposits with the commercial banks is published monthly and in Table 1 the annual increase in these deposits is subtracted from the increase in the government's monetary claims to arrive at an estimate of the increase in the government sector's net claims on the MAS.

The resulting figure is compared in the table with the figure for the increase in 'government deposits' given in the monetary formation table published by the MAS. It can be seen that there is a close agreement between the two figures and this acts as a useful validation of the methodology employed in the derivation of the increase in the government's net claims on the MAS explained above. The MAS monetary formation table is available on a monthly basis and thus the 'government deposits' figure given there provides a short term gauge of the government's contractionary impact on the monetary base, in the absence of any published detailed consolidated balance sheet of the authorities.

An attempt is also made in Table 1 to reconcile those figures for the authorities negative impact on the monetary base with figures derived from the abbreviated balance sheets of the combined monetary authorities published in the IMF's International Financial Statistics. The problem here is that periodically the government invests the bulk of its deposits at the MAS in foreign assets. This operation, when it takes place, results in a large reduction in government deposits at the MAS and a corresponding reduction in the foreign assets of the MAS, thus shrinking the MAS balance sheet. The IMF data correctly consolidate the government's acquired foreign assets back into the monetary authorities' balance sheet, necessarily including an offsetting item as a liability in the 'Net Other Items' category, which can be seen as representing the government's net worth. To obtain an appropriate measure of the government's contractionary effect

TABLE 1
SOURCES OF THE PUBLIC SECTOR'S CONTRACTIONARY IMPACT ON THE MONETARY BASE

	Millions of Singapore Dollars						
	1977	1978	1979	1980	1981	1982	1983
(Official) Public Sector Surplus (deficit = -)	-467	-46	379	36	-474	-553	-49
Contribution to Sinking Fund	382.0	506.1	341.9	1010.0	1769.4	1967.2	2277.4
Net Inflow into the C.P.F.	611.2	694.2	1123.9	1516.9	1939.6	2660.3	2773.1
Increase in Other Domestic Debt	875.2	837.5	621.5	795.8	569.7	953.6	1731.1
Change in Government Deposits with Commercial Banks	-47.0	-250.4	-208.3	-958.3	-476.5	-636.4	-1102.7
(increase in deposits = -)							
Total = Increase in Public Sector Net Claims on the MAS (Estimate)	1354	1741	2258	2400	3328	4392	5630
Source: Ministry of Trade and Industry, MAS							
Increase in Government Deposits	1977	1978	1979	1980	1981	1982	1983
	1487	1868	2055	2659	3531	4722	5022
Source: Monetary Formation Table (MAS)							
Increase in Govt. Deposits at the Monetary Authorities Government's Acquisition of Foreign Exchange	1977	1978	1979	1980	1981	1982	1983
	668	700	896	7	-4584	4329	-2828
Total = Increase in Public Sector Net Claims on the MAS (Estimate)	834	967	914	2053	7272	106	8156
	1502	1667	1810	2060	2688	4435	5328
Source: IMF							

on the monetary base this 'other item' has to be added back into the recorded figure for government deposits, and this is done in Table 1 by adding the government's accumulation of foreign exchange (from government finance figures) to the change in the recorded figure for government deposits at the Monetary Authorities. It can be seen that the resulting figure agrees fairly well with the figures derived from the data published by the Singapore authorities for most of the last seven years (1981 perhaps being something of an exception).

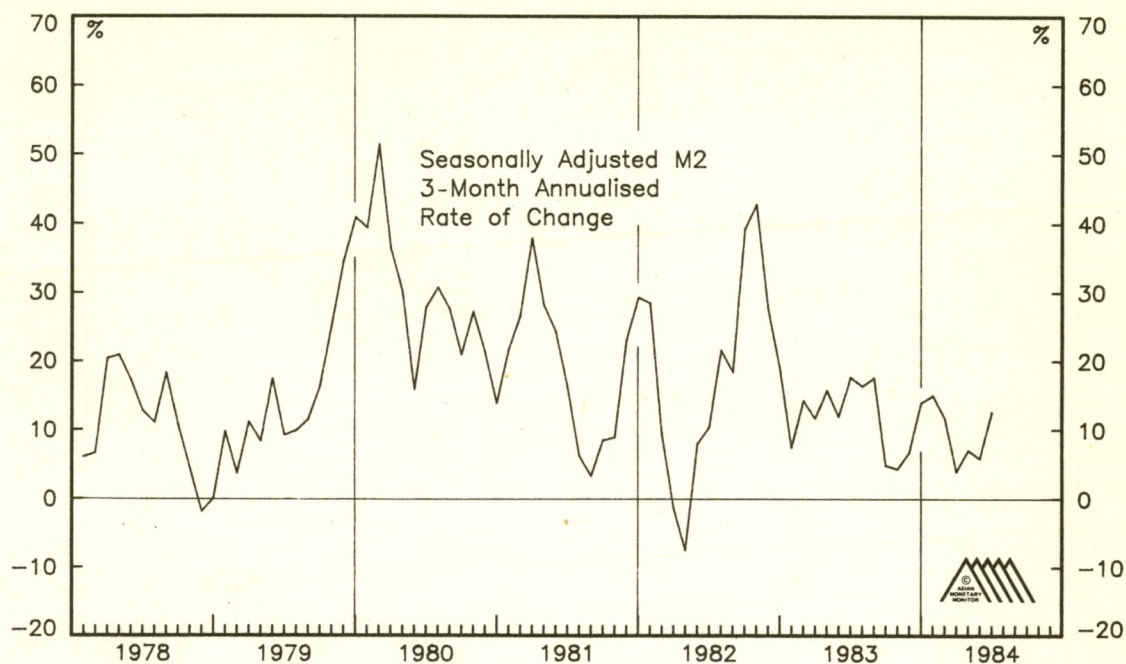
The most striking thing to emerge from the table as a whole is the recent trend, particularly evident since 1980, for the government's contractionary effect on the monetary base to have grown at an increasingly rapid rate, particularly in relation to Singapore's overall balance of payments surplus. For instance (taking a rough average of the figures in Table 1) in 1978 the government's negative impact on the monetary base was roughly in the order of S\$1.7 bn, of similar magnitude to the overall balance of payments surplus in that year, of S\$1.5 bn. By 1980 the government's contractionary effect had grown to about S\$2.5 bn, still not too far out of line with a balance of payments surplus of S\$1.4 bn, but, whereas the overall balance of payments surplus was between S\$1.9 bn and S\$2.6 bn for each of the years 1981-1983, by 1983 the government's negative impact on the monetary base had grown to over S\$5 bn.

The rapid growth in the amount of base money that is naturally withdrawn from the financial system as a by-product of the government sector's operations relative to the potential supply of base money to the system (at the existing exchange rate for the Singapore dollar) arising from the balance of payments via the MAS' operations in foreign exchange, can easily explain both the failure of the Singapore dollar to continue in its rising trend on the foreign exchange markets since 1980, and also the long run downtrend in money growth that has been evident since that year (Charts 1 and 2). However, even given that fact, an admittedly very simple argument could say that even if the MAS had purchased outright each year since 1980 an amount of foreign exchange exactly equivalent to the balance of payments surplus (thus maintaining the exchange rate at a constant level) then, all other things being equal, there would still have been a massive contraction in base money in each of these past three years which, of course, there was not. In reality the figures for the balance of payments surplus and the government's negative impact on the monetary base cannot exactly be compared because of valuation problems arising from exchange rate movements. However, the fact that the exchange rate for the Singapore dollar did remain fairly stable over the period 1980-1983, and that the monetary base continued to grow over these years, suggests that the authorities must have been substantial net suppliers of liquidity to financial institutions through methods other than those purely involving foreign exchange e.g. perhaps MAS operations in the discount market or open market operations in commercial paper. If this were the case, it would go contrary to the accepted view of the operation of monetary policy in Singapore.

If we look at the individual sources of the government sector's monetary contractionary impact presented in Table 1, then no clear trend emerges as to which of the components listed has been most responsible for the sharply increased contractionary effect of the government since 1980. It can be seen that, as might be expected, the CPF has constituted the major contractionary force in each year since 1979, although in 1983 its relative importance was much less than in 1982 when a sharp increase in the CPF's net inflow was the major component of the government sector's markedly increased contractionary impact in that year. CPF contribution rates have continued to be raised each year (although by less in 1983 than in preceding years). The main factor which has latterly acted to reduce the growth of the net inflow into the CPF has been the rapid rate of withdrawals. Members are permitted to withdraw funds upon retirement or under

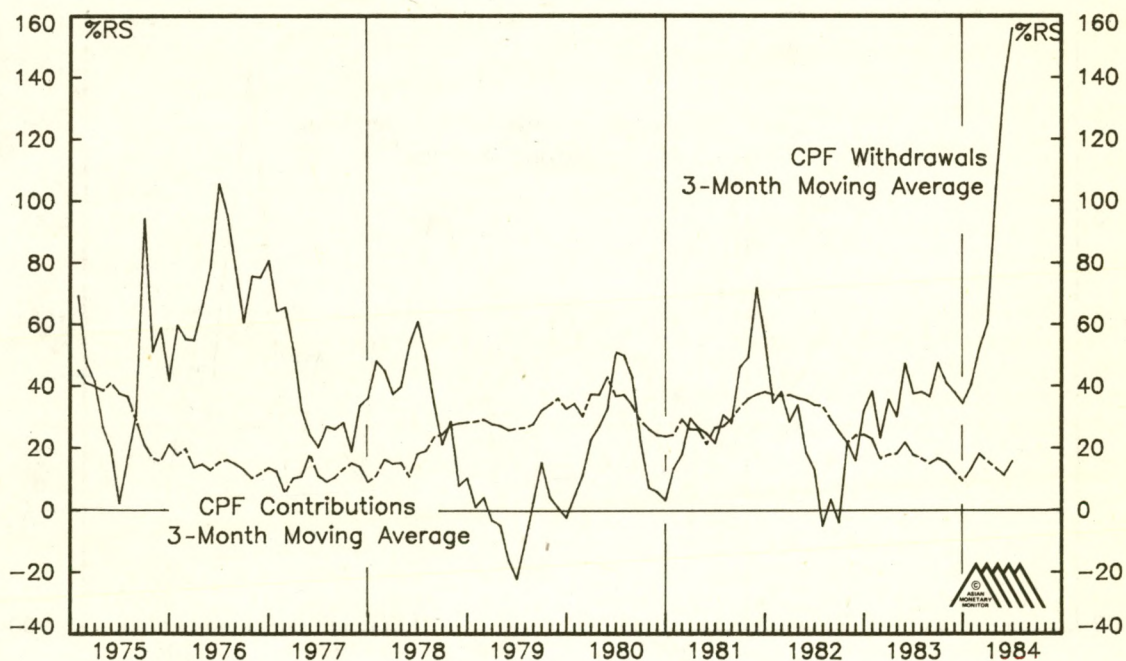
SINGAPORE

CHART 2: SEASONALLY ADJUSTED MONEY

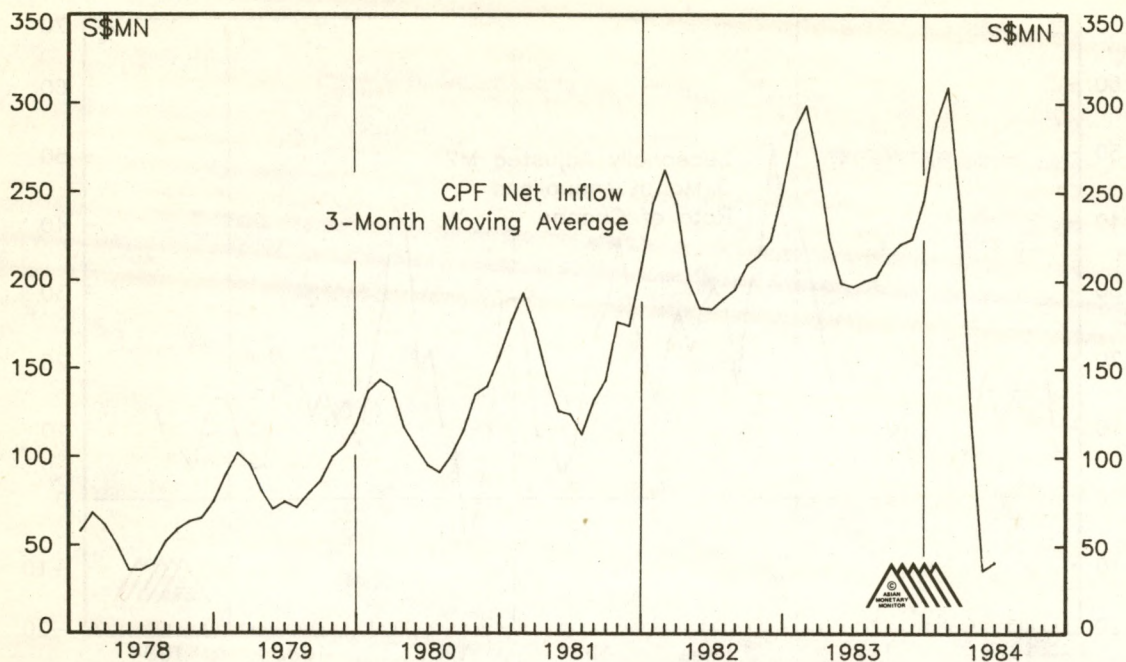


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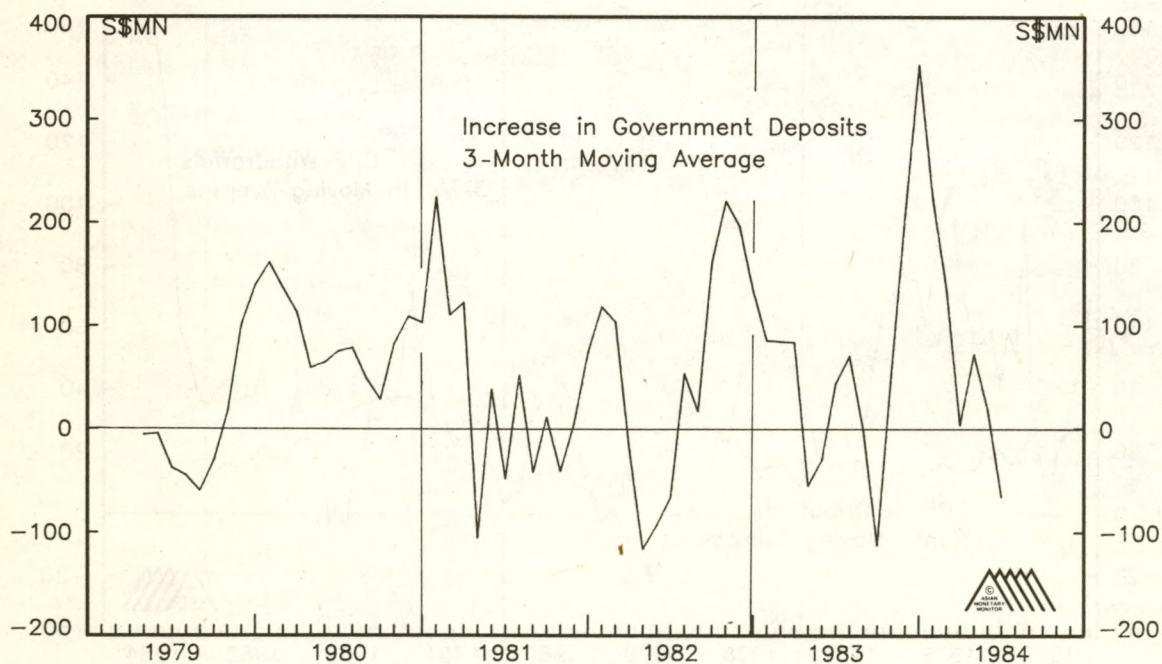
CHART 3: CONTRIBUTIONS TO AND WITHDRAWALS FROM THE C.P.F.



SINGAPORE
CHART 4: NET INFLOW INTO THE C.P.F.



SINGAPORE
CHART 5: GOVERNMENT DEPOSITS WITH THE
COMMERCIAL BANKS



approved schemes, by far the most important of which is the Home Ownership Scheme. Withdrawals of funds for house purchase have accelerated rapidly since early 1982 when the scheme was extended to encompass private, as well as public, housing, and this explains virtually all the recent very sharp acceleration in the rate of withdrawals evident in Chart 3. Despite a rise in the salary ceiling on which CPF contributions are paid, from S\$3,000 to S\$4,000 in November 1983 (which explains the slight blip up in the growth rate of contributions then, noticeable on the Chart), by April of this year withdrawals under the Home Ownership Scheme had reached such a high level that for the first time ever on a monthly basis there was a net outflow from the CPF, making the CPF a net contributor to liquidity in that month. This will prove to have been a temporary phenomenon, however, as it was partly due to seasonal factors (see Chart 4) and also preceded a very large increase in contribution rates in July, when the total contribution rate was raised from 46% to 50% (25% from employer and 25% from employee) and the salary ceiling was raised further, to S\$5,000.

For 1983, as can be seen from Table 1, the most important factors in the marked increase in the government sector's net claims on the MAS were the increase in the public sector's fiscal surplus (when the contribution to the sinking fund is included) and the increase in government debt held outside the CPF. The increase in outstanding government debt is partly accounted for by a S\$6.15 bn bond floatation in the second quarter, not all of which was taken up by the CPF, but can also be partly attributed to an increase in non-CPF advance deposits with the MAS (i.e. deposits which represent the 'waiting list' for future issues of government bonds).

Even though the overall contractionary impact of the government in 1983 was huge, it could have been even larger had it not been for a big increase in public sector deposits at the commercial banks. The Central Government and CPF maintain the bulk of their balances at the MAS and so, other things being equal, an increase in government deposits at the commercial banks is more likely to be attributable to the statutory boards. The statutory boards function independently from the government and work to a budget and hence (at least in the past) have been more likely to keep deposits at commercial banks where they can earn interest. The seven major statutory boards in fact ran a large combined deficit last year - of S\$2.048 bn. However, this is not necessarily inconsistent with a build-up of statutory boards' deposits at commercial banks because the deficit was incurred by the Housing and Development Board (HDB), Public Utilities Board (PUB) and Jurong Town Corporation (JTC), and was financed mainly by loans from Central Government rather than through a rundown in deposits. Thus it is possible that any surpluses incurred by the other statutory boards may have translated into an increase in overall government deposits at the commercial banks. Nevertheless there may have also been a monetary policy element in the recent build-up of government deposits in the commercial banks if the government has been trying at all to divert liquidity back to the banking sector, and consequently the economy.

In this respect the recently legislated amendments to the Banking Act, which allow the MAS to pay interest on all its deposits and provide commercial banking services to government agencies, statutory boards and companies in which the government holds a 20% stake or more, could potentially be very important. If it leads to an even more rapid build-up in government sector deposits at the MAS as the statutory boards now accumulate deposits at the MAS in preference to the commercial banks (as some Singapore bankers fear might happen) then it would obviously be very deflationary. However, it seems unlikely that the authorities would permit this to happen, at least in large degree, and that in such an instance the government would act to divert public sector deposits back into the banking system. Nevertheless, if the recent legislation has any effect on monetary conditions in Singapore at all, it will certainly be in the way of

increasing the bias towards tighter liquidity in the system which exists as a result of the operations of the government sector.

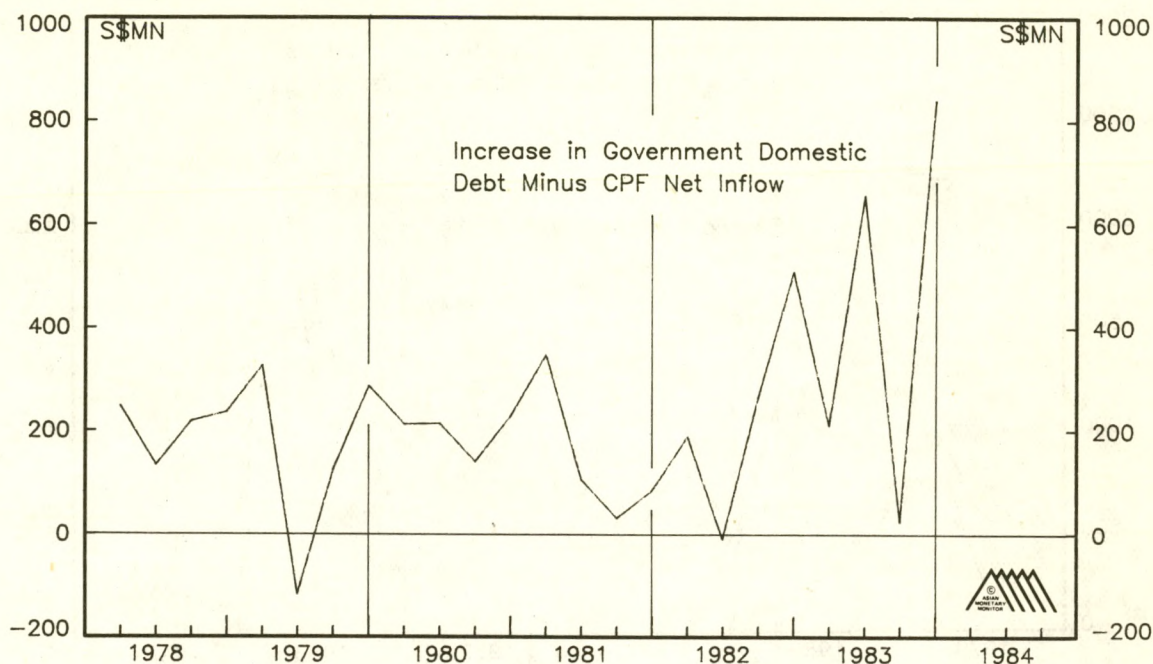
Monthly figures for the total of government deposits held at the commercial banks are available and the three month moving average of the monthly increase in these deposits is plotted on Chart 5. Charts 6 and 7 portray, respectively, the quarterly increase in government domestic debt not held by the CPF and a proxy for the quarterly behaviour of the public sector fiscal surplus. This proxy is derived from taking the IMF figures for the fiscal surplus of the Central Government and adding on a residual factor (assumed to be devoid of seasonal influences) which represents the surplus of the rest of the public sector, and is calculated simply so as to make the annual figures implied by the Chart the same as those given in Table 1.

Thus, between them Charts 4, 5, 6 and 7 depict the shorter run behaviour of the components of the government sector's contractionary influence given in Table 1. In Chart 8 these four components are added together on a quarterly basis to give the total increase in the government's net claims on the MAS. This derived quarterly figure is compared with the quarterly increase in government deposits given in the MAS monetary formation table, as a check, particularly, on the degree of error introduced by the necessity of using an estimate for the public sector's fiscal surplus. It can be seen from this chart that, although on an annual basis the CPF net inflow is the largest single influence on the monetary base, on a short term basis the seasonal influences on the public sector fiscal surplus (where government revenues are to an extent concentrated in the third quarter) and on government deposits with the commercial banks predominate to give the overall increase in the government's net claims on the MAS its seasonal profile. This seasonal profile (highly contractionary in the third quarter, much less contractionary in the fourth quarter) then reinforces the seasonal influences inherent in the balance of payments (see AMM Vol. 8 No. 1) to give money growth its characteristic seasonal pattern.

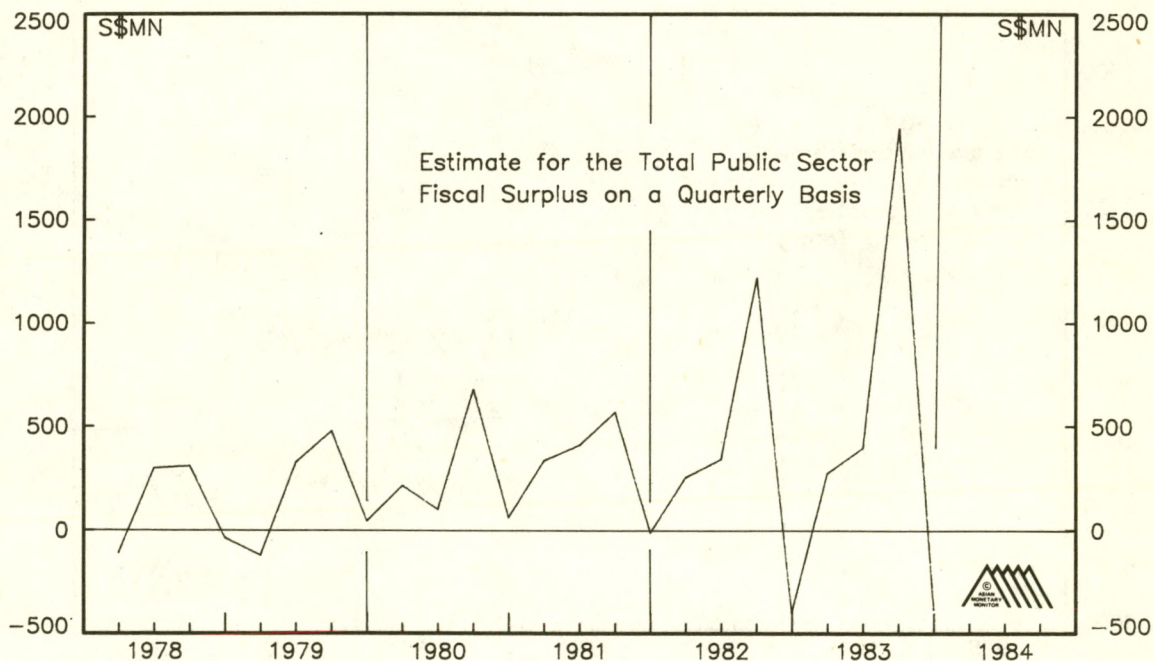
In Chart 9 seasonal factors are eliminated by taking a 12 month moving total of the increase in 'government sector deposits' (from the monetary formation table) and comparing this with the year-on-year rate of M2 growth. From this chart it can be clearly seen that over the last four years the trend towards an ever more rapid build-up in government deposits with the monetary authorities, particularly when looked at in relation to Singapore's balance of payments surplus, has been associated with a general downtrend in the rate of money growth. The cyclical upturn in money growth from the second quarter of 1982 was, of course, the result of a marked improvement in Singapore's balance of payments and this has been well documented in past issues of AMM (AMM Vol. 7 No. 2, AMM Vol. 8 No. 1). Nevertheless, it is notable that a study of trends in the balance of payments alone would suggest that money growth should have reached a higher level at the end of 1982 than at the end of 1980. The fact that it did not can be attributed to the vastly increased contractionary effect of the public sector's operations over the two intervening years.

From Chart 9 it can be clearly seen that the government's contractionary influence on the money supply has significantly decreased over the last ten months. This is clearly attributable to the massive drop in the size of the net inflow into the CPF, discussed earlier. Unfortunately, except for the slight improvement at the end of 1983, money growth has failed to pick up, a fact which does not bode well for the course of liquidity over coming months, as it is probably due to the beginning of a deterioration in the overall balance of payments position.

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CHART 6: LENDING TO THE GOVERNMENT BY
INSTITUTIONS OTHER THAN THE C.P.F.

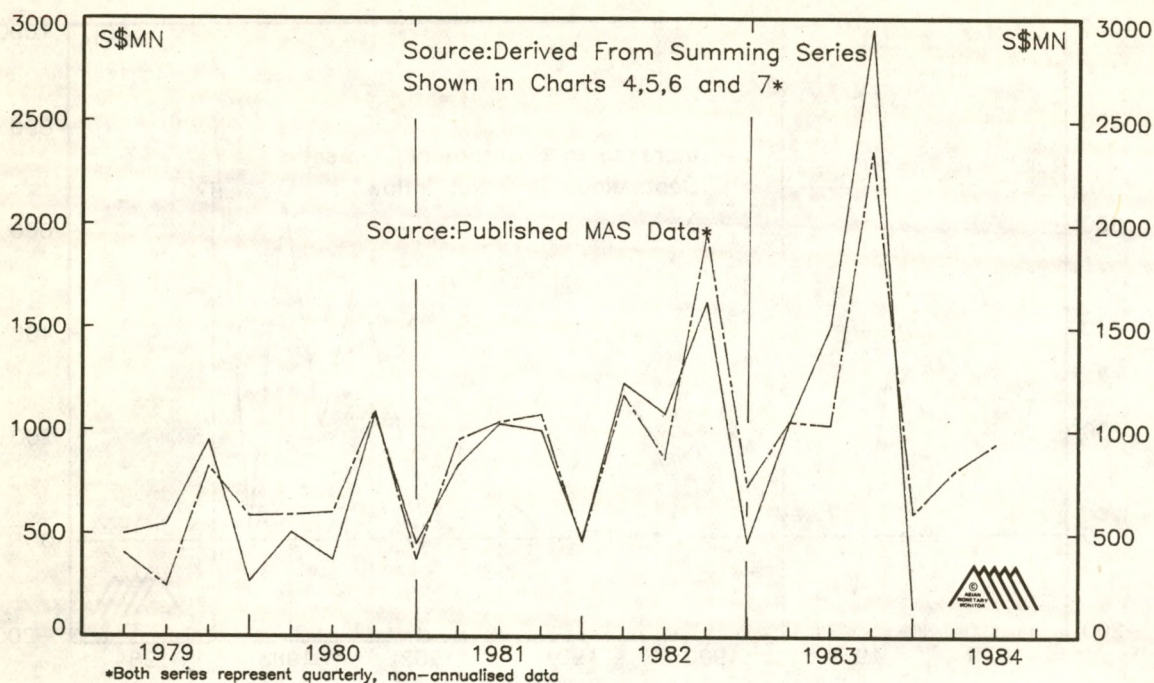


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CHART 7: PUBLIC SECTOR FISCAL SURPLUS



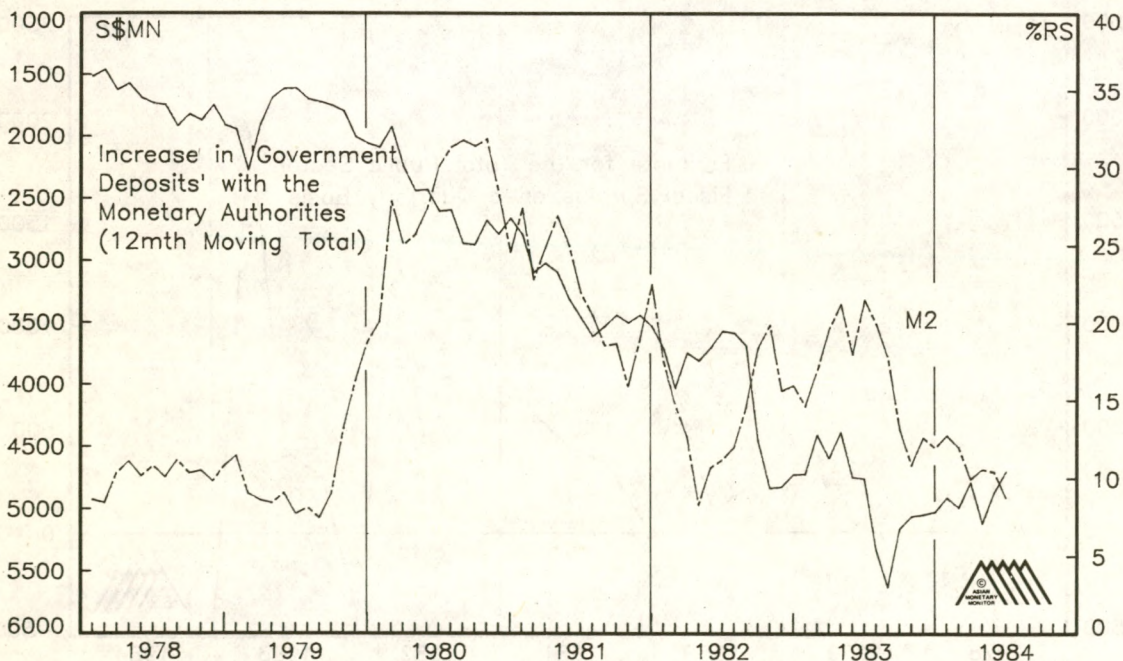
SINGAPORE

CHART 8: THE GOVERNMENT SECTOR'S NEGATIVE IMPACT ON THE MONETARY BASE



SINGAPORE

CHART 9: THE IMPACT OF THE PUBLIC SECTOR'S OPERATIONS UPON MONEY GROWTH



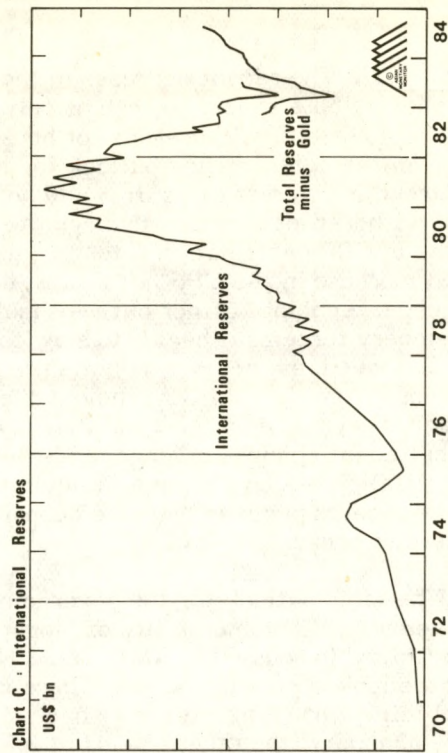
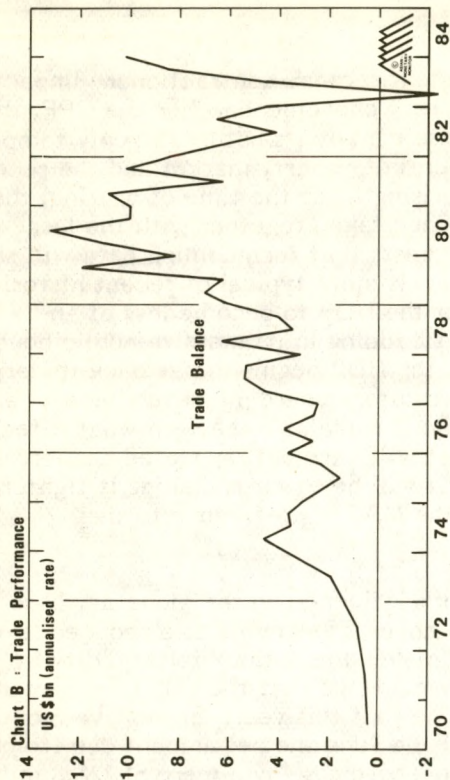
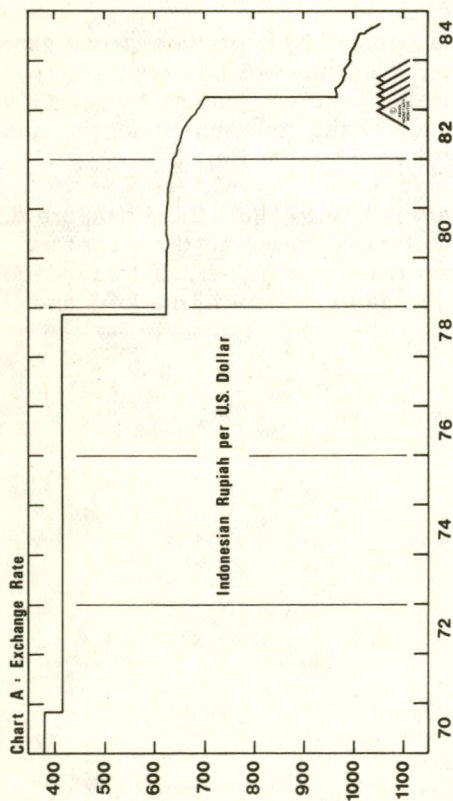
FORECAST : The recent decrease in the government sector's contractionary impact on the monetary base should be seen as only a temporary phenomenon. For the CPF, the recent rapid rate of withdrawals for house purchase can, by its nature, be only temporary and, given the deteriorating outlook for the residential property market and the recent rising trend in interest rates, it would not be surprising if, at the time of writing, the rate of withdrawals had already begun to slow. When taken together with the large increase in CPF contribution rates in July this suggests that forthcoming data will show a marked increase in the CPF net inflow, back to levels more typical of recent historical experience. Looking further out we should expect the HDB to become less of an expansionary force as it begins to slow the rate of building in its massive public housing project. Indeed, as the housing units are sold and the HDB begins to pay back its large borrowings from Central Government the major statutory board may even become a net contractionary force on the money supply. Finally, it remains to be seen what effect, if any, the recent changes in Singapore's Banking Act will have but, as stated earlier, if the new legislation has any impact on liquidity at all it will be towards making it tighter, if statutory boards begin to increase deposits with the MAS in preference to the commercial banks.

When this outlook for the government sector's influence on the monetary base is combined with the vulnerability of Singapore's balance of payments to a reduced level of capital inflow (discussed in AMM Vol. 8 No. 1), it makes the outlook for liquidity in Singapore look very poor indeed. There is already evidence that the rate of monetary capital inflow into Singapore may have slowed somewhat this year. In the five months between January (the recent 'peak' of M2 growth) and June the net amount due from Singapore's commercial banks to banks outside Singapore rose by a mere S\$228.8 million, compared to an increase of S\$1508.8 million in the prior five month period. This reduction in the monetary capital inflow into Singapore can be at least partly attributed to a reduction in the size of the monetary capital flow from Asian Currency Units to domestic Singapore banks.

It may be that liquidity in Singapore can be supported by continued strong growth in Singapore's exports over coming months. However, unless the MAS makes a fairly fundamental change in its monetary policy ultimately the forces leading towards lower money growth (i.e. the growing deflationary tendency of the government sector, and declines in the rate of monetary capital inflow) will take hold again.

Unless the MAS at least modifies its monetary policy to allow the Singapore dollar to fall on the foreign exchanges, we would not be surprised to see all the monetary aggregates showing negative year-on-year growth rates within a year. If this indeed were to be the case it would obviously bode ill for Singapore's capital markets and ultimately the domestic economy itself.

INDONESIAN RUPIAH



Over the period since the devaluation of March 30th, 1983 the Indonesian Rupiah has been gradually managed down against a strong US dollar.

A preliminary glance at Charts B, C and D would suggest that the Indonesian Rupiah is a very sound currency at current levels. Chart D shows that the Rupiah is fairly valued, in terms of relative inflation rates, against the currencies of Indonesia's major trading partners while Charts B and C are illustrative of the marked improvement in Indonesia's balance of payments position over the past year. For the fiscal year ended in March of this year the current account deficit narrowed to US\$4.2 billion from US\$7.3 billion in the previous fiscal year. Part of the recent improvement in the trade account can be explained by an increase in crude petroleum production. (By March/April of this year crude petroleum production was running at levels as much as 40% up from the lows of the first quarter of 1983, with production at nearly 1.6 million barrels per day far exceeding the Opec quota of 1.3 million barrels.) However, non-oil exports have also been encouragingly strong and, following the tight money policy of late 1982 and fiscal austerity of 1983, imports have shown considerable falls.

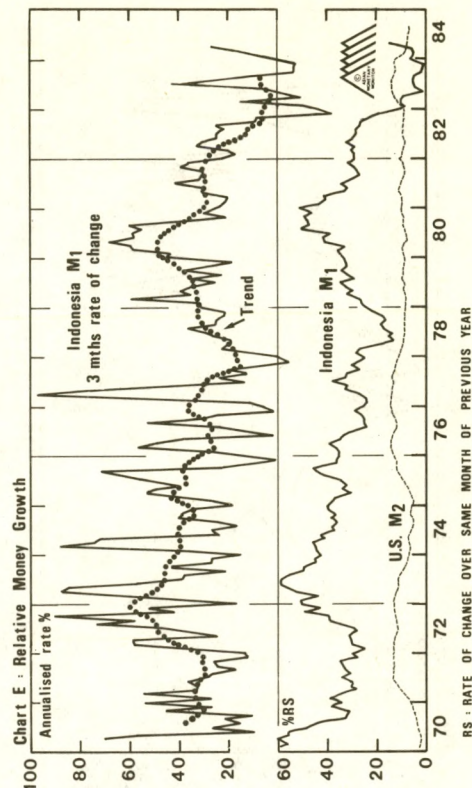
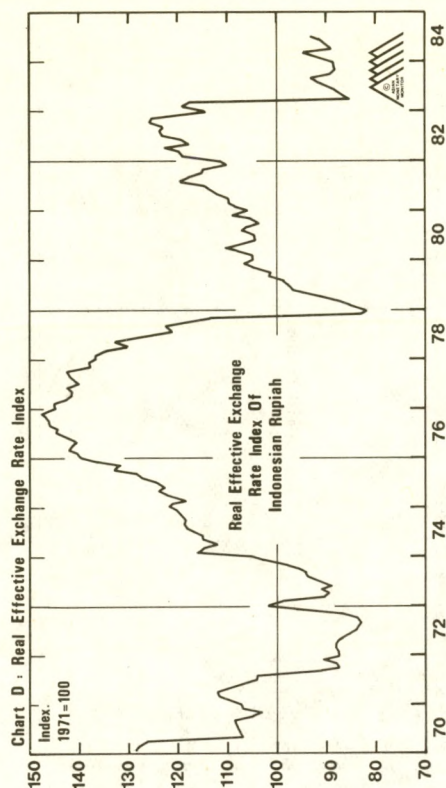
Nevertheless, despite the favourable trend in the external payments position - or, perhaps, partly because of it - an overly lax monetary policy has become a potential negative influence on the Rupiah. The rate of money growth has been increasing since the devaluation (see Chart E) and by the end of June this year the year-on-year rate of monetary base growth had reached 28.6%, compared to only 1.6% in March 1983. The counterpart to this rapid acceleration in the monetary base has indeed been the increase in Bank Indonesia's foreign assets, but in its discretionary actions Bank Indonesia has also revealed a bias towards an easy money policy. This may have been part of a deliberate policy of smoothing the introduction of bank liberalisation and deregulation measures which began in June of last year. Through direct lending to the commercial banks Bank Indonesia has more than offset elements of the bank liberalisation policies which would otherwise have been contractionary (e.g. the switching of loans to state agencies from the Central Bank to the commercial banks, the phasing out of subsidised Central Bank loans to state commercial banks) and has been quick to offset the liquidity tightening effects of occasional bouts of speculation against the Rupiah.

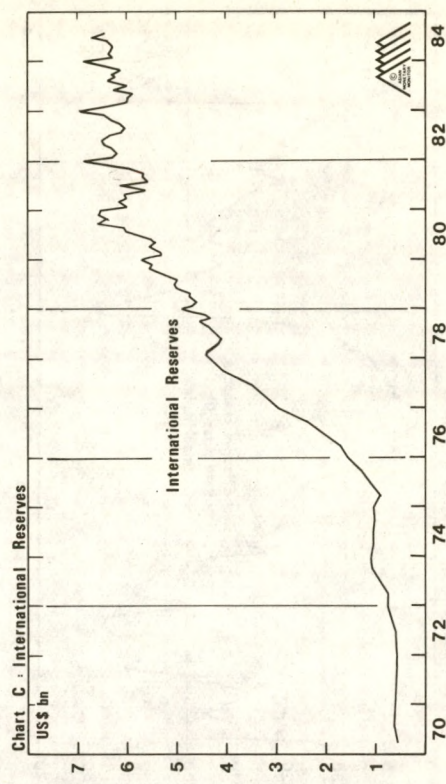
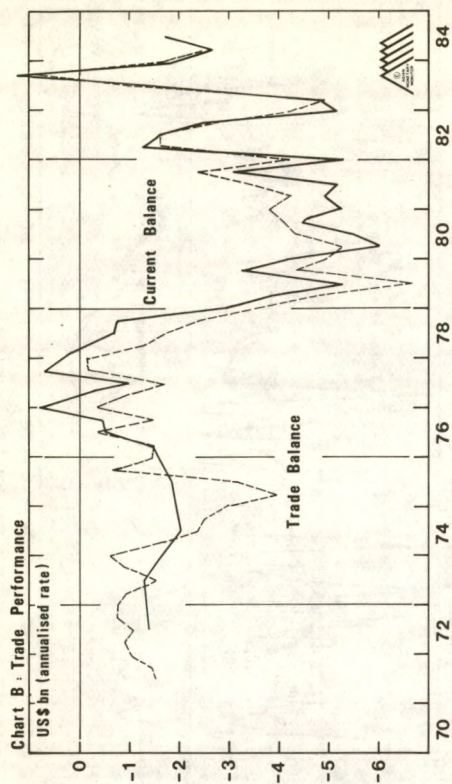
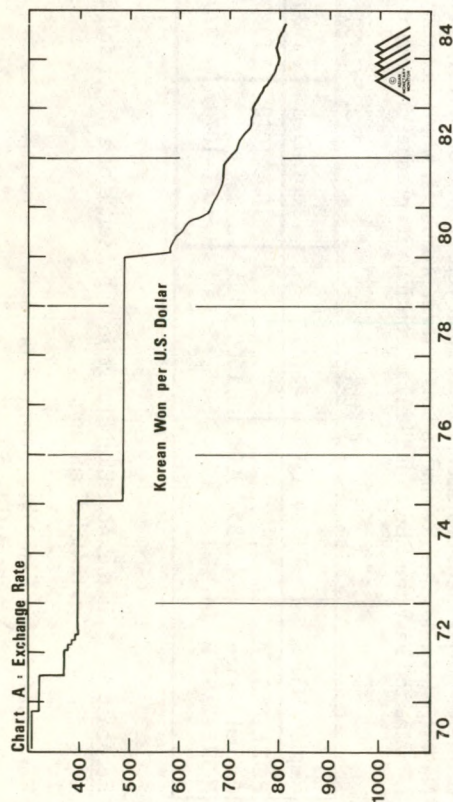
There are grounds for optimism for the longer term. In particular, the phasing out of interest rate and credit controls and the introduction of new monetary instruments have given Bank Indonesia the tools to control the money supply more effectively, if it chooses to do so. On the fiscal side the government has, at least so far, shown admirable restraint in resisting the temptation to let higher revenues translate into increased spending, only a few of the 47 government projects rephased last year having been revived. Nevertheless, despite favourable longer term prospects, while monetary policy remains too easy the Rupiah is likely to continue its gradual downward slide.

Rupiah/US\$	ACTUAL			FORECAST	
	1984 Q1	Q2	Q1	Sept.-Dec.	1985 Q1
	FORECAST A Actual Range FORECAST B	985-1000	1000-1015	1050-1070 1060-1070	1060-1100 1070-1080

Forecast A is the most likely range in the absence of a major political or external disruption.

Forecast B is based on a tentative projection of relative price competitiveness.





The Korean won has held relatively steady against a strong US dollar so far this year. The Won's depreciation against the dollar since the start of January amounts to a little less than 4% and, as a result, the Korean Won has strengthened - often sharply - against a majority of other major currencies.

An analysis of fundamental economic developments in Korea suggests that the relative strength of the Won is sustainable over the longer term. Chart D demonstrates that in spite of the Won's comparative strength against the dollar during the past eighteen months, it appears reasonably valued against the US currency when measured terms of the two economies' relative rates of inflation. This reflects the Bank of Korea's impressive success in stabilising domestic price levels: over the last three and a half years the Korean authorities have reduced consumer price inflation from 36% (December 1980) to 1.7% (July 1984) and wholesale price inflation from 44.2% to 0.9%.

The sharp decline in inflation in Korea during recent years reflects the Bank of Korea's commitment to pursuing a conservative monetary policy. The impact of this policy upon domestic monetary growth is evident in Chart E. The Bank of Korea has reduced sharply the rate of growth in M2 from 33.6%, year-to-year, in October 1982 to 11.0% in the year to June 1984. Moreover, not only has the Bank of Korea curbed successfully monetary growth in the domestic economy but it has also undertaken to stabilise the rate of monetary

growth at a level consistent with price stability. There is, of course, no guarantee that the authorities will in fact adopt such policies in the future, but if they do the longer term outlook will be for the Won to remain relatively firm on the foreign exchanges. Moreover initial indications do suggest that the Bank of Korea is serious in its pursuit of price stability. The central bank has already adopted a target rate of growth for M2 of 12% for 1985 and it has abandoned any commitment to maintaining the external value of the Won at a predetermined level. The Bank of Korea is, therefore, relatively free to exercise direct control over the rate of growth of the monetary base and can thereby ensure that its monetary target is achieved successfully. Price stability in the domestic economy would likely ensure the longer term strength of the Won.

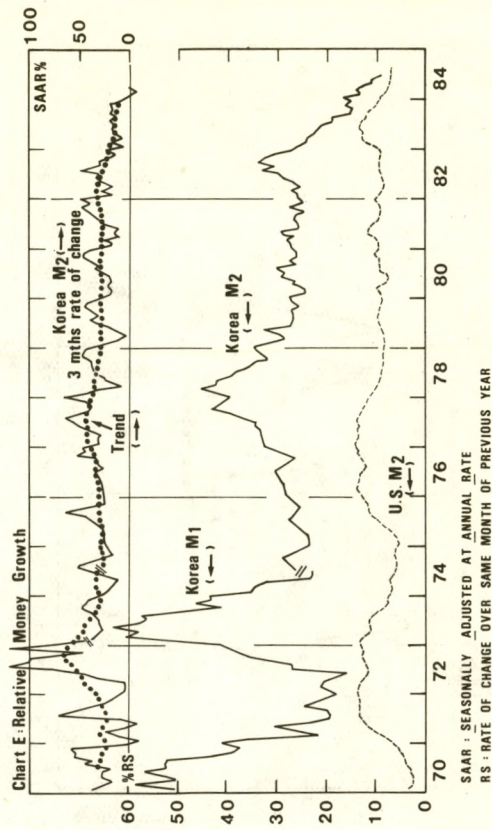
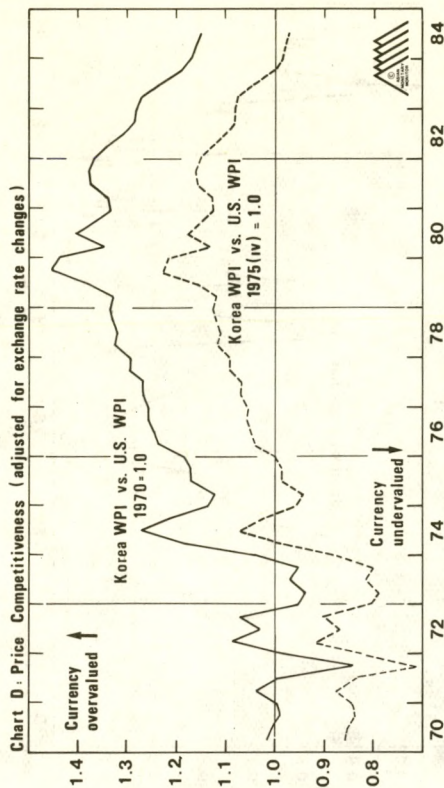
On a cyclical perspective, too, the Won appears likely to maintain its relative strength on the foreign exchanges. Korea - with an historically low rate of inflation - has been well placed to benefit from a strong recovery in the US and in Japan and its exports have risen sharply. (The value of exports rose by 41% in 1983.) As a result, the improvement in Korea's trade and current account position has been sustained (see Chart B) and has been accompanied by a further rise (Chart C) in Korea's International Reserve holdings.

ACTUAL FORECAST

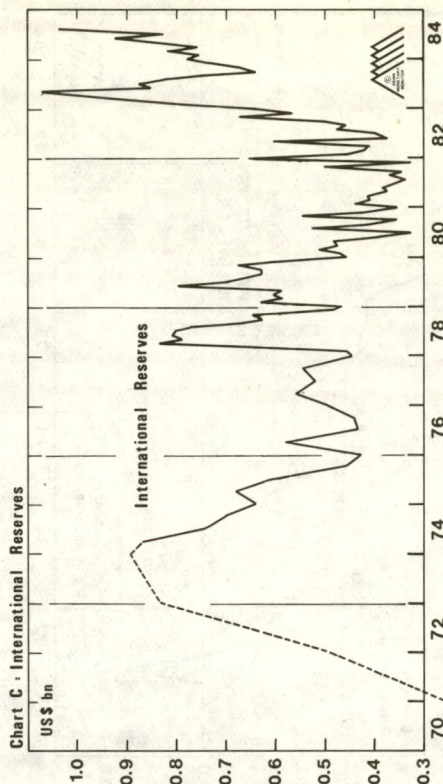
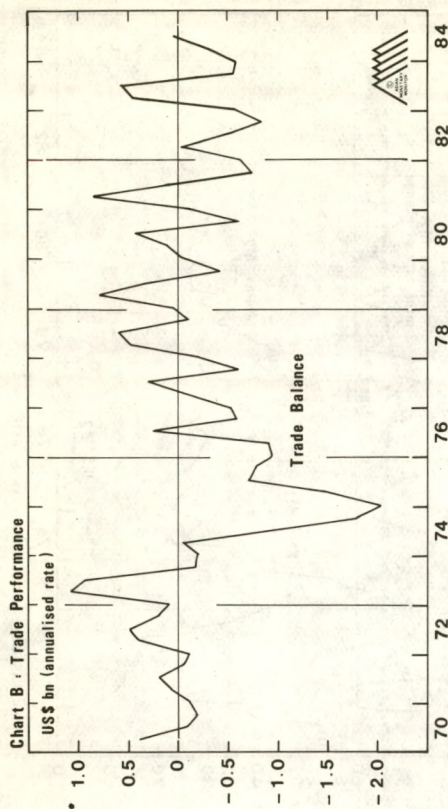
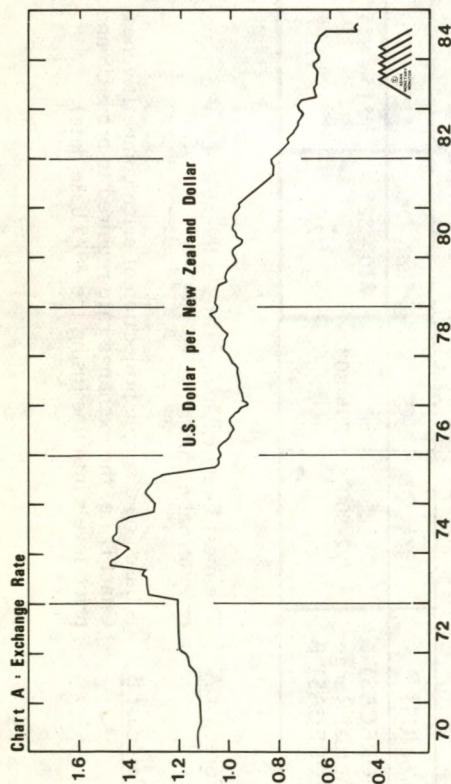
Won/US\$	1984 Q1	Q2	Sept.-Dec.	1985 Q1
FORECAST A				
Actual Range	792-800	794-803	810 - 825	815 - 835
FORECAST B			775	770

Forecast A The most likely exchange rate in the absence of a major political or external disturbance.

Forecast B is based on a simple projection of price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line (using the 1975 base date).



NEW ZEALAND DOLLAR



On July 14th, the New Zealand Labour Party scored a convincing General Election victory over the incumbent National Party - and the Prime Minister elect, Mr. David Lange, was immediately faced with a serious financial crisis. During the campaign period there had been intense speculation against the New Zealand dollar culminating in an unprecedented private capital outflow of, Reserve Bank officials estimate, some NZ\$1.4 billion. On Monday July 16th the Prime Minister elect closed the local foreign exchanges and on July 18 he announced a formal 20% devaluation of the New Zealand dollar. That day, the New Zealand dollar opened for trading at US\$0.4950: the local currency had lost two thirds (see Chart A) of its value against the US dollar in a decade.

At the time of the devaluation, the New Zealand government simultaneously announced an end to the artificially low interest rate policy which had been pursued by its predecessor. This policy, which had led to higher monetary (Chart E) and credit growth and which threatened to lead to higher inflation, must be counted as a crucial fundamental cause of declining confidence in the currency.

The size of the devaluation - which was approximately five percentage points larger than many observers had anticipated - and the removal of

regulated ceilings on interest rates and the expectation of greater financial orthodoxy has succeeded in restoring confidence in the New Zealand dollar, at least for the time being. The local currency has traded in the narrow range of US\$0.4865 - US\$0.5015 since the devaluation.

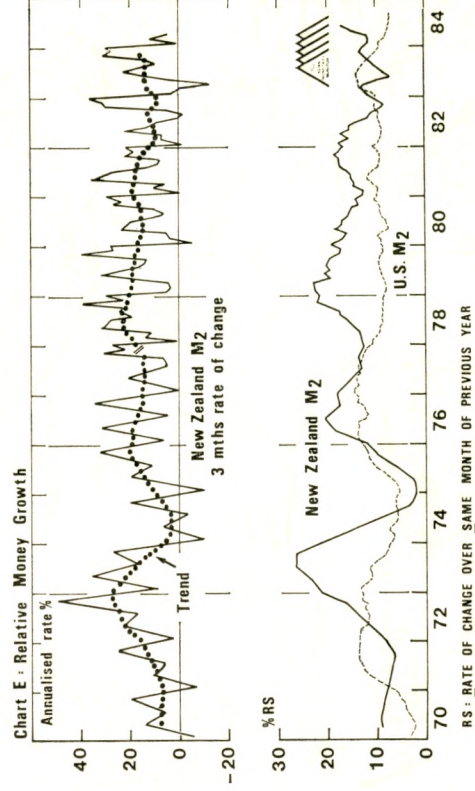
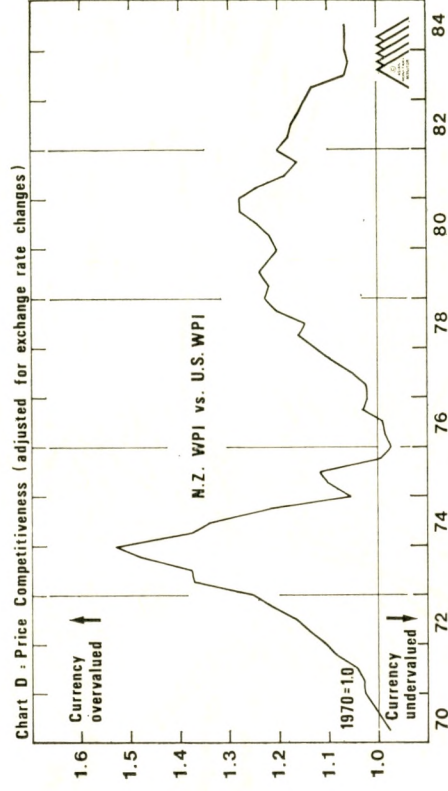
It is reasonable to suppose that the relative stability of the New Zealand dollar over the past two months reflects partly a similar lack of volatility in the Australian dollar/US dollar exchange rate. The New Zealand dollar continues to be managed against a basket of currencies and it is realistic for investors to presume that the Australian dollar carries a large weight in that basket.

Nevertheless, shorter term considerations aside, the New Zealand economy is beset with a range of serious problems which suggest that the local currency may continue to be fundamentally weak. Inflation is now set to rise in New Zealand, in the aftermath of 16% growth in both M1 and M3 in the year to July, and in spite of a renewed prices and wages freeze. Official forecasts indicate that consumer price inflation will double, to 8%, during 1985. In addition, New Zealand suffered a current account deficit of NZ\$1.8 billion in the year to July. In order to subdue domestic inflation and to bring about an improvement in the external account the New Zealand authorities will have to exercise prolonged restraint in their macro-economic policies. If such a stance is indeed undertaken the long term weakness in the New Zealand dollar may, finally, be arrested. But it is clear that such restraint will depress the private sector of the New Zealand economy - already burdened by a government fiscal deficit amounting to 9% of GNP - and it remains to be seen whether or not the authorities will sanction a prolonged period of negligible real growth.

US\$/NZ\$	ACTUAL			FORECAST	
	1984	Q1	Q2	Sept.-Dec.	1985 Q1
FORECAST A				0.46 - 0.49	0.42 - 0.48
Actual Range		0.648-0.675	0.631-0.666		
FORECAST B				0.46 - 0.49	0.40 - 0.48

Forecast A assumes no further tightening in US monetary policy and that orthodox restraint is implemented in New Zealand.

Forecast B assumes more restrictive US monetary growth after the November US Presidential elections.

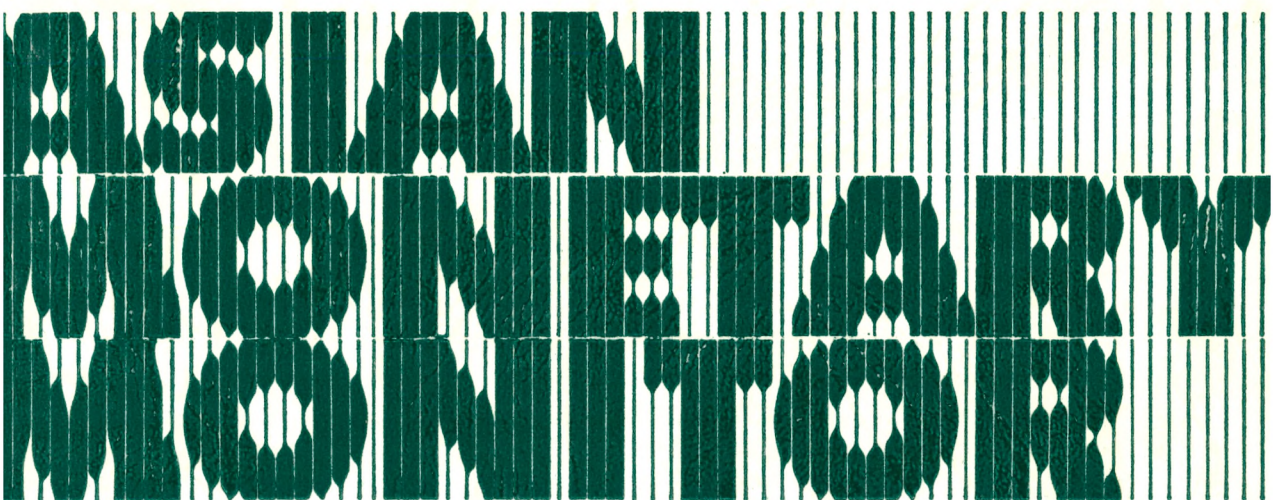




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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

SURVEY ARTICLE

SOME RECENT DEVELOPMENTS IN THE FREE WORLD OIL MARKET

Introduction

In December 1980, the Libyan, Nigerian and Venezuelan authorities successfully offered their domestic oil production for sale - on short term contracts - at US\$40 per barrel. This price represented a substantial premium to the then "marker price" (for Saudi light crude) of US\$34 per barrel. This price difference was officially explained as representing a justifiable market premium for higher quality (lower sulphur content, "sweeter") crude petroleum. Nevertheless, it may have appeared at the time that the OPEC cartel was under pressure primarily because Saudi Arabia refused to sanction a higher marker price for oil.

By contrast, it is at present evident that the price of oil is under downward pressure. The marker price of Saudi light has been reduced to US\$29 per barrel. The spot price of oil has traded at a (sometimes substantial) discount to official market prices consistently during the last three years. The futures market in oil and oil related products has occasionally discounted a market spot price for oil of approximately US\$25. A growing proportion of commentators, it would appear, lack confidence that the market price for oil can be sustained at its current level. This may be reflected in the large increase in the proportion of oil purchases and sales now conducted on the spot market rather than on medium or longer term contracts. The Petroleum Intelligence Review estimates that some 40%-45% of free world transactions in crude oil are now conducted on the spot market, compared with only a small fraction in 1978.

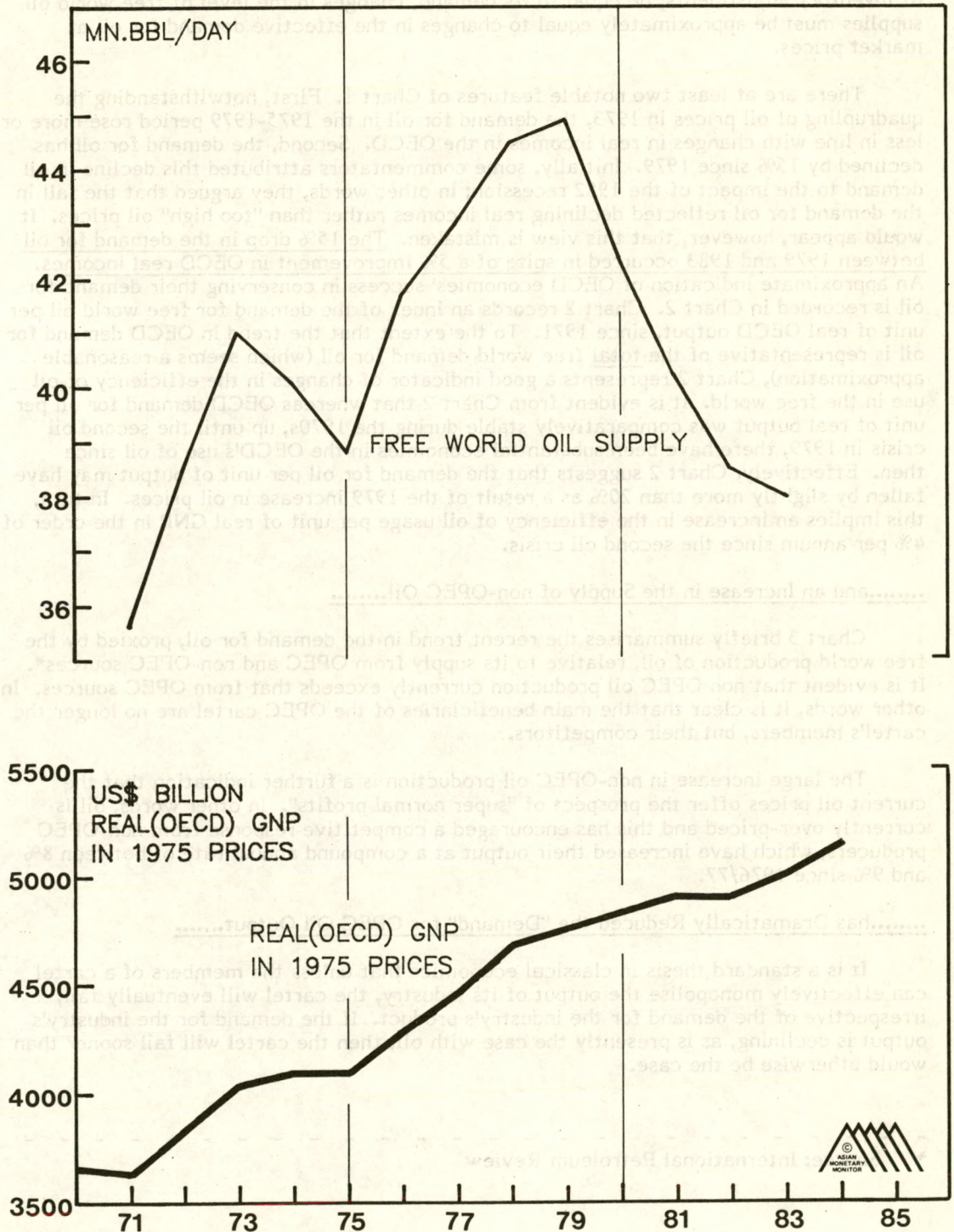
It is a fact that the members of the OPEC cartel have gone to great lengths in order to limit the decline in the price of oil. The OPEC cartel has restricted its output to an estimated 18 million barrels per day in 1983, down by a factor of more than one third from the 31 million barrels per day produced during 1977, 1978 and 1979. OPEC's collective oil output reductions have had a very substantial adverse impact on the current account position of the cartel members. OPEC's net current account position has been transformed from a surplus of US\$45 billion in 1979 to a deficit of US\$23 billion in 1983*. Saudi Arabia has borne an unequal burden in limiting the decline in oil prices. Saudi oil production has fallen from peak levels of 11-12 million barrels per day in the summer of 1980 to as low as 4 1/2 million barrels per day recently. As a result, the Saudi share of OPEC production has declined from roughly one third in 1978-1981 to around one quarter over the last twelve months.

However, in spite of the large cutbacks in OPEC production over the last four years, fundamental pressures continue to build for a substantial reduction in oil prices. In a sense, it is obvious that oil prices are under downward pressure; after all, prices have declined during a period of moderately strong recovery in the major oil consuming economies and at a time of heightened hostilities in the Middle East. However, the fundamental evidence outlined below seems to suggest that oil prices may eventually decline by a margin greater than is generally thought likely.

* Source IMF: International Financial Statistics

CHART 1

THE SUPPLY OF FREE WORLD OIL AND THE LEVEL OF REAL(OECD) GNP



A Reduction in the Demand for Oil.....

Chart 1 records the level of "free world" supplies of oil and level of real OECD GNP since 1971. Since the effective supply of oil at prevailing market prices must, net of inventory adjustments, be equal to its demand, changes in the level of free world oil supplies must be approximately equal to changes in the effective demand for oil at market prices.

There are at least two notable features of Chart 1. First, notwithstanding the quadrupling of oil prices in 1973, the demand for oil in the 1975-1979 period rose more or less in line with changes in real incomes in the OECD. Second, the demand for oil has declined by 15% since 1979. Initially, some commentators attributed this decline in oil demand to the impact of the 1982 recession; in other words, they argued that the fall in the demand for oil reflected declining real incomes rather than "too high" oil prices. It would appear, however, that this view is mistaken. The 15% drop in the demand for oil between 1979 and 1983 occurred in spite of a 5% improvement in OECD real incomes. An approximate indication of OECD economies' success in conserving their demand for oil is recorded in Chart 2. Chart 2 records an index of the demand for free world oil per unit of real OECD output, since 1971. To the extent that the trend in OECD demand for oil is representative of the total free world demand for oil (which seems a reasonable approximation), Chart 2 represents a good indicator of changes in the efficiency of oil use in the free world. It is evident from Chart 2 that whereas OECD demand for oil per unit of real output was comparatively stable during the 1970s, up until the second oil crisis in 1979, there have been substantial economies in the OECD's use of oil since then. Effectively, Chart 2 suggests that the demand for oil per unit of output may have fallen by slightly more than 20% as a result of the 1979 increase in oil prices. In turn, this implies an increase in the efficiency of oil usage per unit of real GNP in the order of 4% per annum since the second oil crisis.

.....and an Increase in the Supply of non-OPEC Oil.....

Chart 3 briefly summarises the recent trend in the demand for oil, proxied by the free world production of oil, relative to its supply from OPEC and non-OPEC sources*. It is evident that non OPEC oil production currently exceeds that from OPEC sources. In other words, it is clear that the main beneficiaries of the OPEC cartel are no longer the cartel's members, but their competitors.

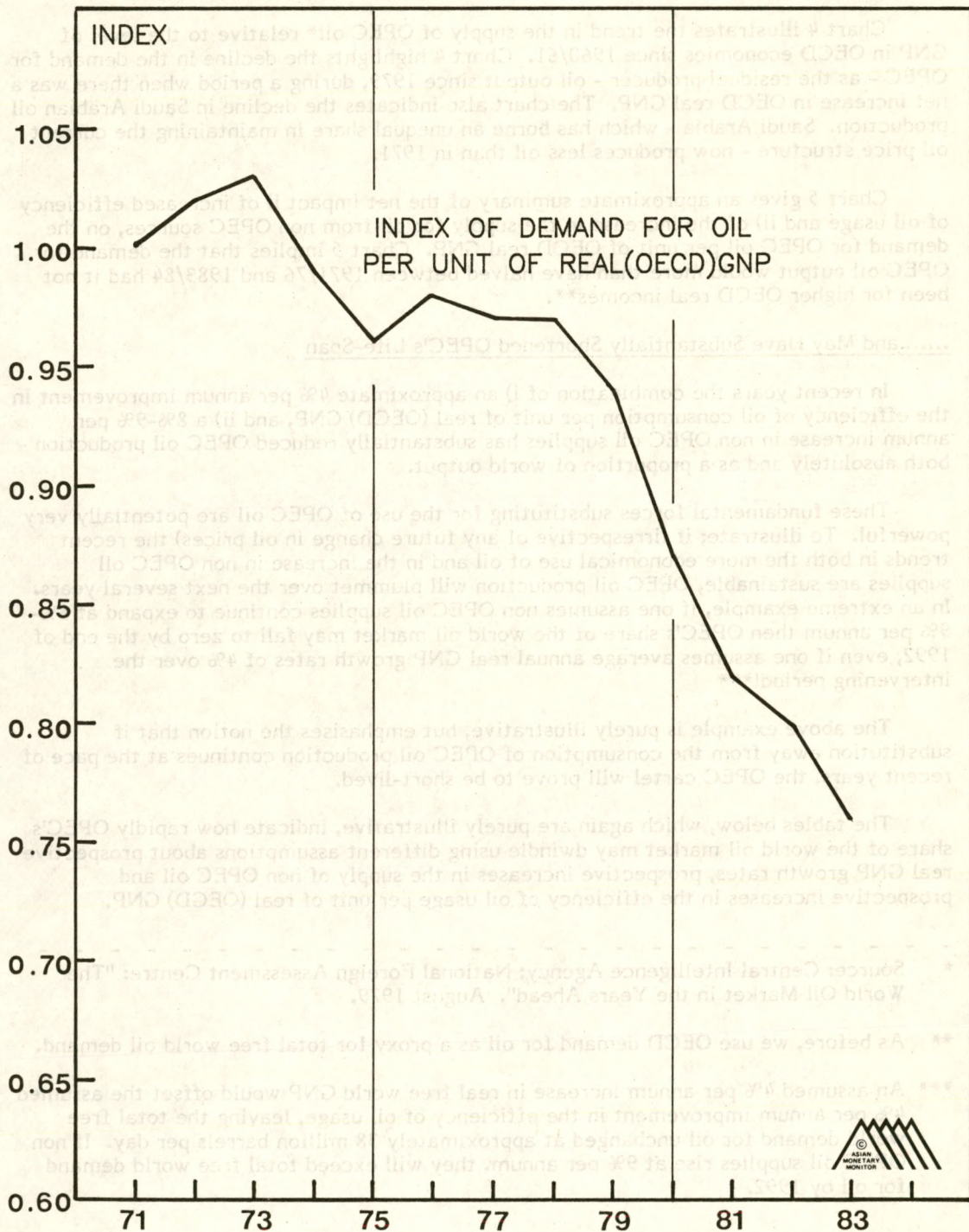
The large increase in non-OPEC oil production is a further indication that the current oil prices offer the prospect of "super normal profits". In other words, oil is currently over-priced and this has encouraged a competitive response from non-OPEC producers, which have increased their output at a compound annual rate of between 8% and 9% since 1976/77.

.....has Dramatically Reduced the "Demand" for OPEC Oil Output.....

It is a standard thesis in classical economics that unless the members of a cartel can effectively monopolise the output of its industry, the cartel will eventually fail, irrespective of the demand for the industry's product. If the demand for the industry's output is declining, as is presently the case with oil, then the cartel will fail sooner than would otherwise be the case.

* Source: International Petroleum Review

CHART 2 AN INDEX OF THE DEMAND FOR OIL PER UNIT OF REAL(OECD) GNP



The OPEC cartel is caught in a pincer between increased efficiency of oil usage and increased (usually non-price) competition from non-OPEC producers. From OPEC's perspective, the Cartel is now in the unenviable position of being the residual supplier in the world oil market.

Chart 4 illustrates the trend in the supply of OPEC oil* relative to the level of GNP in OECD economies since 1960/61. Chart 4 highlights the decline in the demand for OPEC - as the residual producer - oil output since 1979, during a period when there was a net increase in OECD real GNP. The chart also indicates the decline in Saudi Arabian oil production. Saudi Arabia - which has borne an unequal share in maintaining the current oil price structure - now produces less oil than in 1971.

Chart 5 gives an approximate summary of the net impact i) of increased efficiency of oil usage and ii) of the increase in the supply for oil from non OPEC sources, on the demand for OPEC oil per unit of OECD real GNP. Chart 5 implies that the demand for OPEC oil output would more than have halved between 1971/76 and 1983/84 had it not been for higher OECD real incomes**.

.....and May Have Substantially Shortened OPEC's Life-Span

In recent years the combination of i) an approximate 4% per annum improvement in the efficiency of oil consumption per unit of real (OECD) GNP, and ii) a 8%-9% per annum increase in non OPEC oil supplies has substantially reduced OPEC oil production - both absolutely and as a proportion of world output.

These fundamental forces substituting for the use of OPEC oil are potentially very powerful. To illustrate; if (irrespective of any future change in oil prices) the recent trends in both the more economical use of oil and in the increase in non OPEC oil supplies are sustainable, OPEC oil production will plummet over the next several years. In an extreme example, if one assumes non OPEC oil supplies continue to expand at 8%-9% per annum then OPEC's share of the world oil market may fall to zero by the end of 1992, even if one assumes average annual real GNP growth rates of 4% over the intervening period!***

The above example is purely illustrative, but emphasises the notion that if substitution away from the consumption of OPEC oil production continues at the pace of recent years, the OPEC cartel will prove to be short-lived.

The tables below, which again are purely illustrative, indicate how rapidly OPEC's share of the world oil market may dwindle using different assumptions about prospective real GNP growth rates, prospective increases in the supply of non OPEC oil and prospective increases in the efficiency of oil usage per unit of real (OECD) GNP.

* Source: Central Intelligence Agency; National Foreign Assessment Centre: "The World Oil Market in the Years Ahead". August 1979.

** As before, we use OECD demand for oil as a proxy for total free world oil demand.

*** An assumed 4% per annum increase in real free world GNP would offset the assumed 4% per annum improvement in the efficiency of oil usage, leaving the total free world demand for oil unchanged at approximately 38 million barrels per day. If non OPEC oil supplies rise at 9% per annum, they will exceed total free world demand for oil by 1992.

CHART 3

THE SUPPLY OF OIL FROM OPEC AND NON-OPEC SOURCES

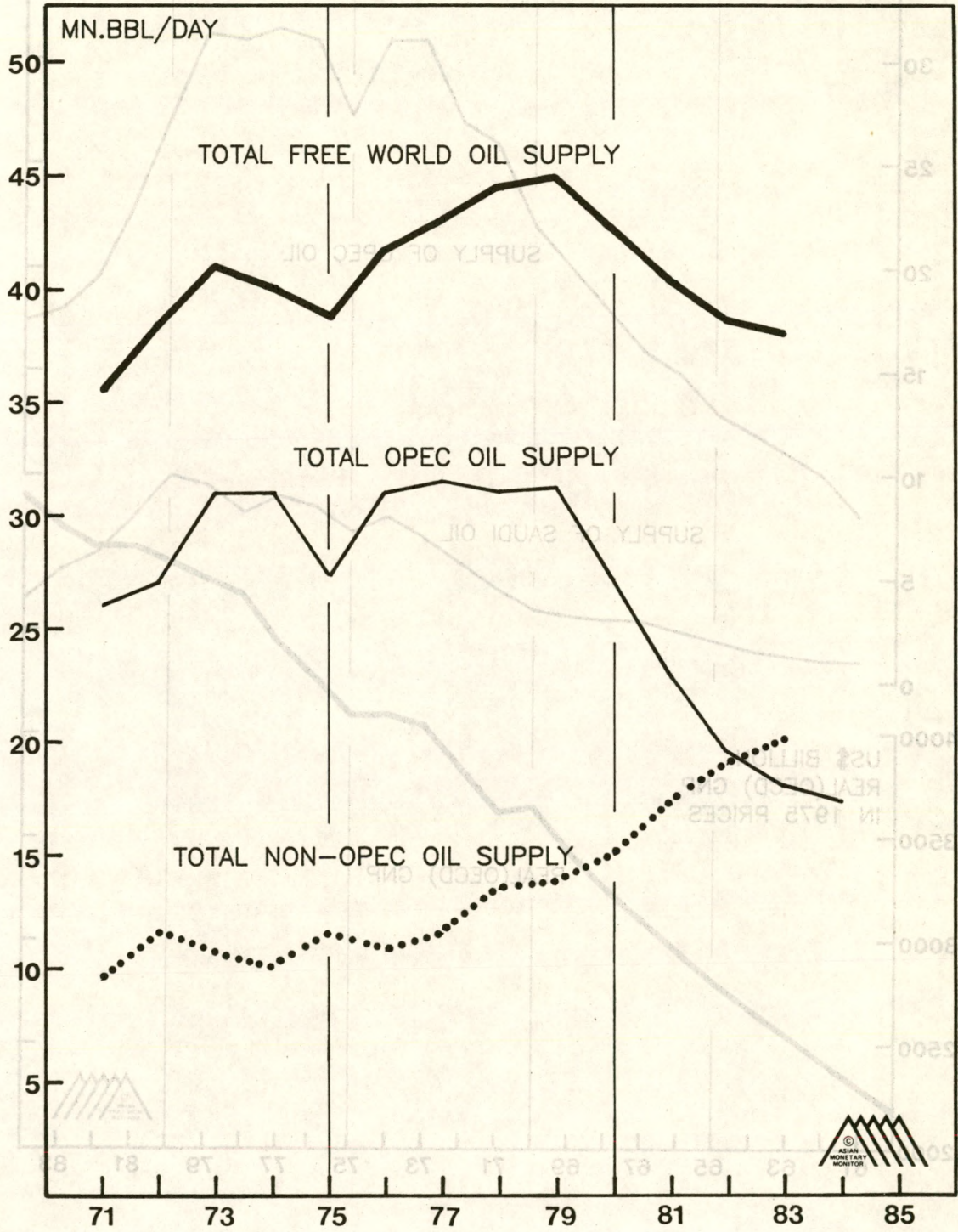


CHART 4

THE SUPPLY OF OPEC OIL AND THE LEVEL OF REAL(OECD) GNP

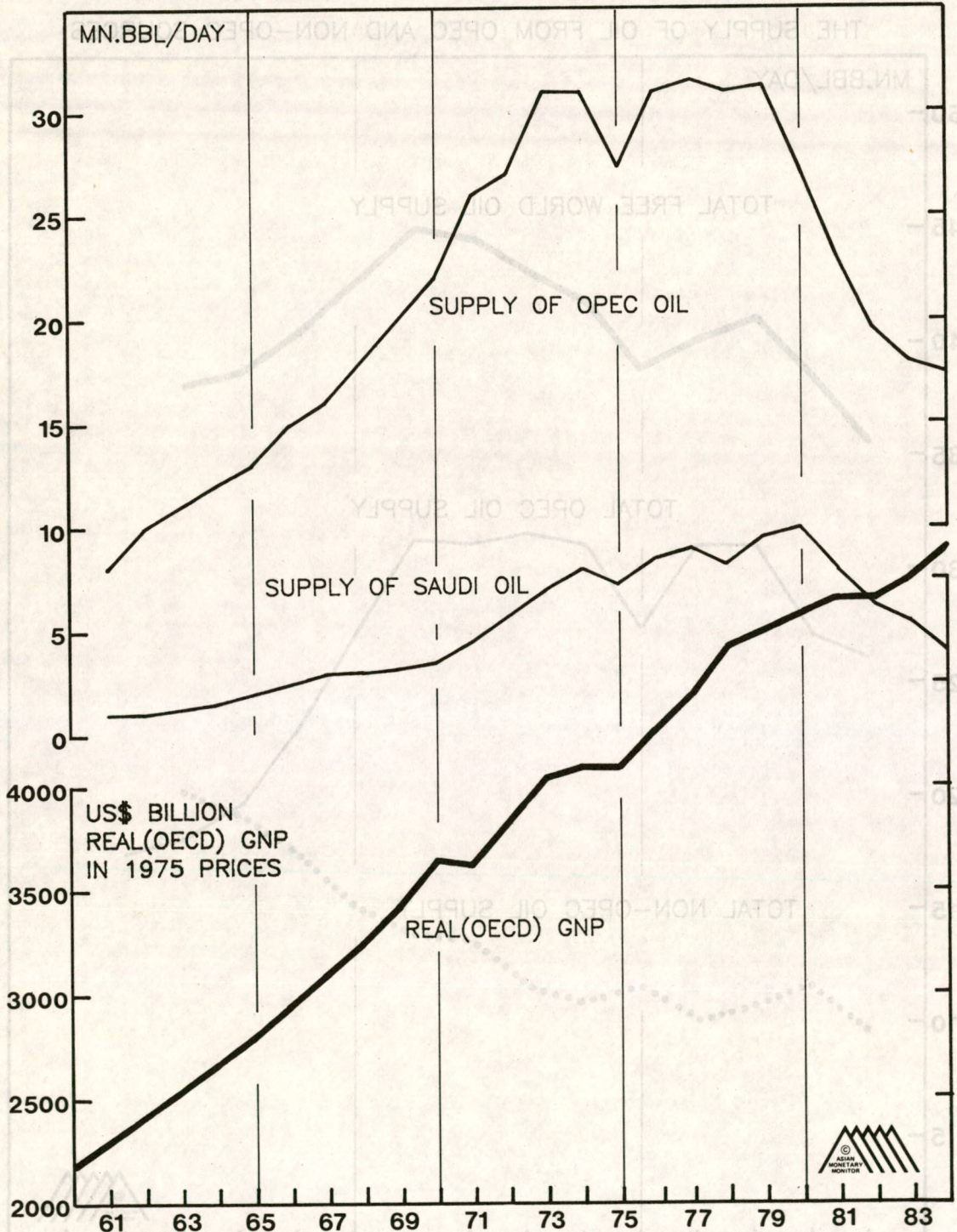


CHART 5

AN INDEX OF THE DEMAND FOR OPEC OIL PRODUCTION
PER UNIT OF REAL(OECD) GNP

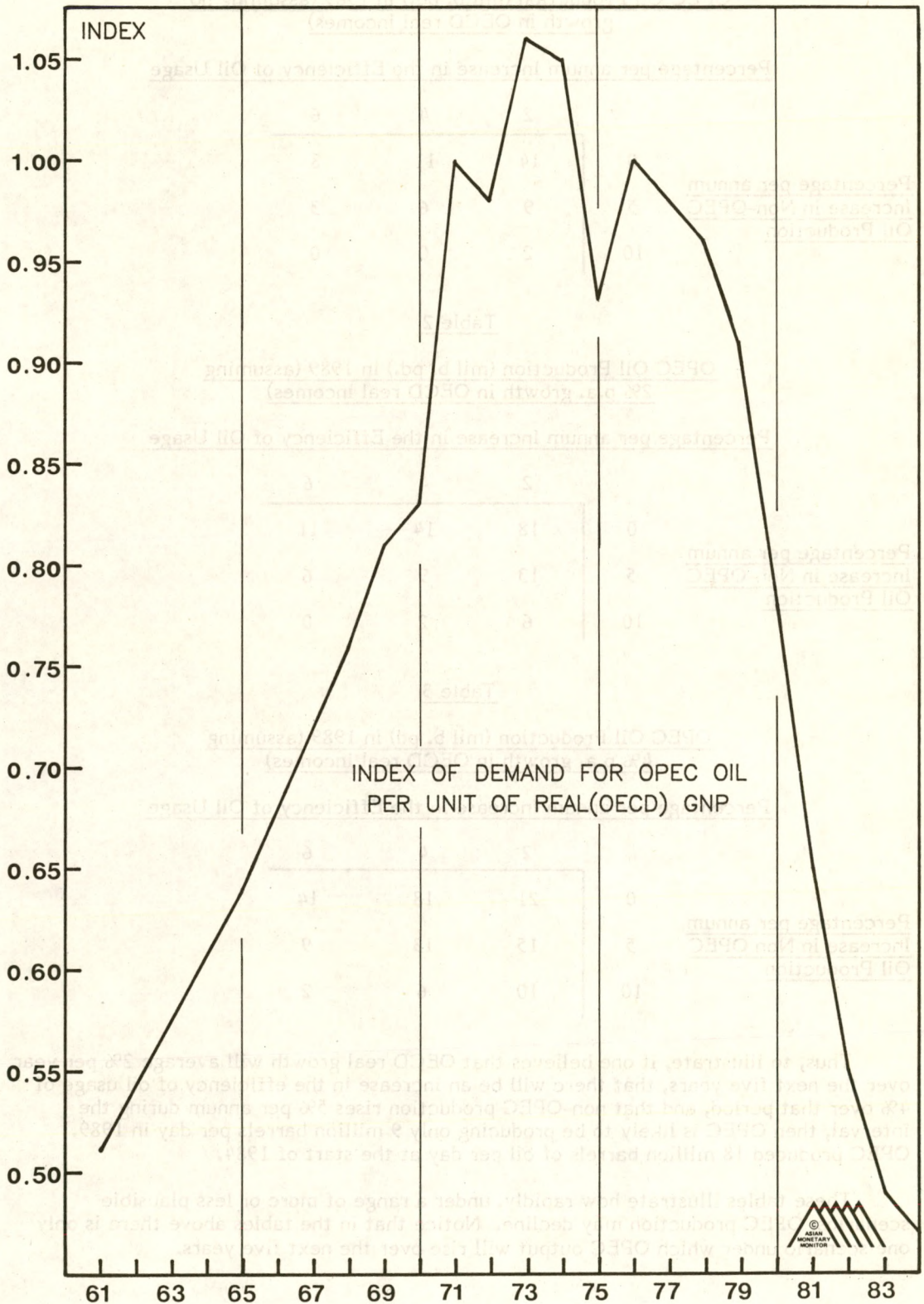


Table 1

OPEC Oil Production (mil b. pd.) in 1989 (assuming no growth in OECD real incomes)

Percentage per annum Increase in the Efficiency of Oil Usage

		2	4	6
<u>Percentage per annum Increase in Non-OPEC Oil Production</u>	0	14	11	8
	5	9	6	3
	10	2	0	0

Table 2

OPEC Oil Production (mil b. pd.) in 1989 (assuming 2% p.a. growth in OECD real incomes)

Percentage per annum Increase in the Efficiency of Oil Usage

		2	4	6
<u>Percentage per annum Increase in Non-OPEC Oil Production</u>	0	18	14	11
	5	13	9	6
	10	6	2	0

Table 3

OPEC Oil Production (mil b. pd) in 1989 (assuming 4% p.a. growth in OECD real incomes)

Percentage per annum Increase in the Efficiency of Oil Usage

		2	4	6
<u>Percentage per annum Increase in Non OPEC Oil Production</u>	0	21	18	14
	5	15	13	9
	10	10	6	2

Thus, to illustrate, if one believes that OECD real growth will average 2% per year over the next five years, that there will be an increase in the efficiency of oil usage of 4% over that period, and that non-OPEC production rises 5% per annum during the interval, then OPEC is likely to be producing only 9 million barrels per day in 1989. OPEC produced 18 million barrels of oil per day at the start of 1984.

These tables illustrate how rapidly, under a range of more or less plausible scenarios, OPEC production may decline. Notice that in the tables above there is only one scenario under which OPEC output will rise over the next five years.

Oil Price Implications

It seems clear that the implications of the above analysis are bearish of the medium to long term outlook for oil prices. The general picture is weak, with the demand for oil declining over the last five years in spite of an increase in real incomes in the OECD, but this poor situation is exacerbated by the decline in the demand for OPEC - the residual producer - output*. The current level of oil prices is plainly conditional upon the strength of the OPEC cartel. Evidently, since 1979, the OPEC cartel has been weakened. OPEC production has fallen by 35% whilst official marker prices have declined by five dollars, to US\$29. These actions to support the price of oil have not however alleviated the fundamental sources of stress to the cartel. Non-OPEC oil supplies have risen whilst at the same time the major oil consuming economies have conserved their use of this commodity.

Whilst it is feasible that non-OPEC oil supplies will not increase as rapidly in the future as over the past decade, it is our judgement that efforts to conserve oil use will remain strong. Rather than anticipating a reduction in efforts to conserve oil usage, we should not be surprised if the oil consuming economies enhance the efficiency with which they consume oil. In other words it is possible, though perhaps not probable, that the decline in oil usage per unit of real output will be larger than the 4% per annum which, we estimate, has occurred since 1979. Official price cuts notwithstanding, oil remains an expensive commodity to a large proportion of its consumers. For example, the price of oil to W. German consumers, because of the Deutschemark's decline against the dollar, currently stands nearly 2% higher than at the time of the Iranian hostage crisis in mid 1980. There is still a considerable incentive to conserve oil consumption. This incentive to reduce oil consumption will likely be brought to practical effect as oil consuming economies modernise and refurbish their capital stock. The implication of this is that sustained recovery in oil consuming economies should be thought of as a mixed blessing for the oil producers. Certainly a higher level of real income will, other things equal, increase the demand for oil, but sustained recovery also affords the opportunity to install more (oil) efficient capital equipment. It is probably no coincidence that the major economy (Japan) with the most sustained growth over the past decade has also, we believe, been the most successful in conserving oil consumption. The potential for improved efficiency of oil use is very considerable. Recent estimates suggest that contemporary US automobile models are approximately 80% more fuel efficient than their counterparts were in 1974.

A further reason for believing that efforts to conserve oil use may rise, not fall, over the longer term is evidence from the experience of the mid to late 1970s. Chart 2 shows that the OECD consumption of oil per unit of real output was comparatively stable after the first oil crisis. Nominal oil prices were fairly stable in the 1975-1979 period, but real oil prices fell by as much as one third. It is interesting to note that the relative consumption of oil was basically unchanged whilst the real price of the commodity declined substantially. This may imply that even at the 1975-79 oil price, consumers were keen to conserve their use of oil.

Although the OPEC cartel has been weakened it remains, clearly, a major force in the oil market. Unfortunately there is little in the above analysis to suggest how much "weaker" OPEC will become before its declining share of oil output is reflected in a major slump in oil prices. Nevertheless, if the trends in both non-OPEC production and oil use conservation continue as over the last five years, it is clear that OPEC - the residual producer in the oil market - will be forced, each year, to reduce its output by between 1 1/2 million and 2 million barrels per day in order to maintain current price levels. In the end, obviously, such a strategy must prove hopeless.

* OPEC's recent experience bears out an important prediction of the theory of cartels, first formulated by Robert Liefmann, "Die Kartelle", 1905. The existence of a cartel is symptomatic of industry or product weakness. Growing industries don't form cartels.

Investors should think in terms of the price of oil declining to the levels of the mid 1970s (i.e. to between US\$10 and US\$15 per barrel) at some stage over the next five to ten years. The choice of a price of US\$10 to US\$15 per barrel of oil is not solely a guess: this is the price range, approximately adjusted for inflation, within which the relative use of oil (see Chart 2) was stable. And it would appear that a reversal in the trend towards reduced use of oil per unit of output is the minimum we should look for before the bear market in the oil price is over.

Whilst it is feasible that non-OPEC oil supplies will not increase as rapidly in the future as over the past decade, it is our judgement that efforts to conserve oil usage, we remain strong. Rather than anticipating a reduction in efforts to conserve oil usage, we should not be surprised if the oil consuming economies enhance the efficiency with which they consume oil. In other words it is possible, though perhaps not probable, that the decline in oil usage per unit of real output will be larger than the 4% per annum which we estimate has occurred since 1973. Official price cuts notwithstanding, oil remains an expensive commodity to a large proportion of its consumers. For example, the price of oil to W. German consumers, because of the Deutschmark's decline against the dollar, currently stands nearly 2% higher than at the time of the Iranian hostage crisis in mid 1980. There is still a considerable incentive to conserve oil consumption. This incentive to reduce oil consumption will likely be brought to practical effect as oil consuming economies modernise and replace their capital stock. The implication of this is that sustained recovery in oil consuming economies should be thought of as a mixed blessing for the oil producers. Certainly a higher level of real income will, other things equal, increase the demand for oil, but sustained recovery also affords the opportunity to install more (oil) efficient capital equipment. It is probably no coincidence that the major economy (Japan) with the most sustained growth over the past decade has also, we believe, been the most successful in conserving oil consumption. The potential for improved efficiency of oil use is very considerable. Recent estimates suggest that contemporary US automobile models are approximately 80% more fuel efficient than their counterparts were in 1974.

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OPEC's recent experience bears out an important prediction of the theory of cartels, first formulated by Robert L. Lerner, "Die Kartelle", 1902. The existence of a cartel is symptomatic of industry or product weakness. Growing industries doubt

INDIA

A BRIEF OUTLINE OF INDIA'S MONETARY EXPERIENCE SINCE 1970

The aim of this article is to present a first review of the conduct of monetary policy in India since 1970 and to describe the use of principal policy instruments in achieving official credit and monetary targets. The environment in which monetary policy is formulated and practised in India differs greatly from that typical of more developed economies in the West and in the Asian Pacific Rim. Nevertheless a basic analysis of India's monetary experience should start with the same precepts as those used in the examination of monetary and banking systems in more developed countries. What are the Reserve Bank and central government's immediate monetary or credit targets? How are these targets achieved? What is the relationship between changes in the level of the targets chosen and changes in the level of the authorities' ultimate objectives - inflation, nominal incomes etc.?

The Formulation of Monetary Policy in India: the Choice of Intermediate Monetary Targets

The Indian authorities face the same basic technical options as other monetary authorities in their choice of an intermediate monetary target. In the long run the Reserve Bank may either control directly the rate of expansion of the monetary base or it may exercise indirect control over the base by managing or pegging the external value of the Rupee or by regulating the level of short term interest rates. Direct or indirect control over the expansion of the monetary base helps enable the Reserve Bank exercise control over the rate of growth of banks' balance sheets as a first step in formulating macro-economic policy.

In the short run, however, the Reserve Bank may temporarily evade the choice between direct and indirect control over the monetary base by exercising direct constraints - through credit controls - over the growth rate and composition of commercial banks' balance sheets. In a highly regulated, centrally planned economy such as India's - where all major financial institutions have been nationalised - direct controls on banks' balance sheets may have an intuitive appeal. But, if in the course of conducting monetary policy through the implementation of credit controls the monetary base is allowed to grow at an excessive rate the Indian authorities will find themselves confronted with the same problems as in any other economies where similar policies have been pursued. If the monetary base is allowed to grow at an excessive rate then commercial banks (and other financial institutions), over time, will generally find ways to circumvent credit controls and hence will expand their balance sheets: money and credit growth will thus rise until orthodox - either direct or indirect - policies are implemented to reduce expansion in the reserve base.

Direct Monetary Base Control has not Featured Strongly in Indian Monetary Policy

Vault cash and banks' deposits at the Reserve Bank are the only reservable assets in the Indian banking system. Indian commercial banks are required to hold a specified minimum (currently, 9%) level of reserves - the Cash Reserve Ratio - against their eligible liabilities. Thus, in theory, central bank direct control over the reserve base could provide adequate control over the growth of banks' balance sheets in India.

In practice, however, neither monetary base nor money supply targeting have played an important role in either the strategy or tactics of Indian monetary policy since 1970. The reasons for this are straight forward. First, the Reserve Bank of India lacks both short and medium term control over the reserve base. Second, in any event, the

Reserve Bank is generally reluctant to try to exercise direct control over the base because this would imply a desire to restrain the absolute size of banks' balance sheets whereas, in practice, the Indian authorities are as interested in influencing the composition of banks' balance sheets.

Underlying both reasons for trying to avoid direct control over the monetary base is the Indian authorities' stated objective to try to achieve a more "desirable" distribution of incomes in the domestic economy. In practice, a key element of the policy to redistribute income shares have been to increase substantially the relative size of the government sector and to allocate (credit) resources to certain preferred sectors of the economy.

The increase in the relative size of the government sector has been accompanied by a large increase in the Indian authorities' domestic fiscal deficit and an increased proportion of this deficit has been monetised by the Central Bank. Central Bank net lending to the government has become by far the largest source of the monetary base. Because yields on government obligations are artificially low* the Reserve Bank acts effectively as the residual source of finance for the fiscal deficit and hence effective control over the rate of growth of the base lies mainly with the central government rather than with the Reserve Bank.

The authorities' desire to allocate credit to preferred sectors of the economy is a further impediment to the practical use of monetary base control. For example, if the Indian monetary authorities sought to restrict monetary growth this may normally imply pro-rata reductions in the growth of the various classifications of banks' assets. It would also imply a general increase in the cost of credit. In practice, however, the Indian central authorities have been extremely reluctant to ration the availability of bank credit to preferred sectors of the economy. For example, commercial bank credit to finance the purchase of food grains have never been rationed. The perceived need to ensure that bank credit is readily and cheaply available to certain borrowers is a clear constraint to the implementation of monetary policy through monetary base and money supply targeting.

Indirect Control over the Monetary Base does not Appear to have Featured in Indian Monetary Policy

The Rupee is a managed currency. The authorities' regulation of the external value of the currency will, therefore, indirectly impact the growth of the monetary base through changes in the balance of payments.

The announced official guidelines for management of the Indian Rupee are sketchy. The Rupee is managed against an unspecified basket of currencies where the Pound Sterling is the intervention currency. The Reserve Bank states that official management of the Rupee is undertaken such that i) in the short term, the Sterling/Rupee rate fluctuates by no more than 2 1/2% each week and ii) in the long term, the Rupee's nominal effective exchange rate against the basket of currencies does not deviate by more than 5% either side of the level pertaining in June 1975, when the managed exchange rate policy was inaugurated.

However, since the Reserve Bank publishes neither the composition nor the weights of the components of the basket, observers have no way of checking whether or not the long term policy has been maintained. In the absence of other official statements or evidence it is therefore difficult to assess or describe the objectives of Indian foreign exchange rate policy. We surmise however - although this remains uncertain - that the

* Three month Treasury Bills currently yield 4 1/2%, compared with a current inflation rate of 14%.

Reserve Bank does not manage the external value of the Rupee with the explicit or acknowledged intention of influencing indirectly the growth of the reserve base. Essentially the arguments are similar to those set out above. Any attempt to control indirectly the growth of the monetary base through management of the exchange is likely eventually to prove unworkable if, as in India's example, growth in the base is mainly determined by the expansion in net central bank lending to the government. Moreover even if the Indian authorities were generally able to influence the base indirectly, the use of the exchange rate as an indirect instrument of monetary policy is likely to be heavily constrained by the authorities' desire not to restrict credit to certain sectors of the economy.

Commercial Bank Credit to "Non-Preferred" sectors of the Economy: The Principal Target for Monetary Policy

In practice, the Reserve Bank has attempted to circumvent the choice between direct and indirect control over the base by targeting growth in certain categories of banks' assets. Since 1970, the Reserve Bank has focused mainly on the category of commercial bank non-food credit and has generally sought to achieve its "target" for growth in this classification of banks' assets by enforcing credit controls.

However, the manner in which the Indian authorities arrive at their "target" for growth in commercial bank non-food credit underlines the weaknesses inherent in this approach to formulating monetary policy. Essentially, the Reserve Bank utilises a residual estimation technique in reaching its target for commercial bank non-food credit. The Reserve Bank tries to estimate the total resources available for lending by the commercial banks, deducts prior "claims" on these resources implied by the Cash Reserve Ratio, the Statutory Liquidity Ratio* and by lending to preferred sectors of the economy and arrives at a residual "target" for non-food credit. However, it is evident that the authorities cannot accurately forecast the total resources available for lending by the commercial banks unless they can anticipate growth in the monetary base. Any unanticipated change in the rate of growth of the reserve base will, over time, lead to the Reserve Bank undershooting or overshooting their target for commercial bank non-food credit.

A Brief Description of the Conduct of Monetary Policy since 1970

Chart 1 records the trend in the monetary base in India since 1961, together with the components of the base. Chart 1 highlights the rapid growth in net central bank lending to the government as the principal source of the growth in the base since 1970. Charts 1 and 2 together provide a useful summary reference point in outlining India's recent monetary experience. The recent experience may be divided into four intervals.

1971-1974: Higher Monetary Growth Precedes Sharply Higher Inflation

As in majority of other economies, India experienced a monetary boom and higher inflation during the early part of the 1970s. M1 growth doubled between 1970 and 1973 (see Chart 2) and consumer price inflation accelerated from 2%, year-to-year in mid-1971 to more than 30% in 1974.

* Commercial banks and other financial institutions must hold a proportion, currently equal to 36% of total demand and time deposits, of their total assets in eligible liquid securities (Federal government securities, authorised state and local obligations and securities where both principal and interest payments are Federally guaranteed). Since 1970 the SLR ratio has been increased from 26% to 36%. This increase mainly reflects the increased role of the public sector in the Indian economy: the rise in the SLR ratio has increased effectively the "captive market" for unattractively priced government obligations.

During 1971/72 and 1972/73, monetary policy was conducted against the background of a domestic economy severely weakened by a prolonged period of drought, poor food grain production and famine in parts of the country. The drought was one cause of a steady rise in the government's fiscal deficit between 1971 and 1974. The fiscal deficit was also boosted by a political commitment to increase substantially defence expenditure, following the Indo-Chinese wars in 1969 and 1970.

The increase in the fiscal deficit was accompanied by a greater than proportionate rise in Reserve Bank net lending to the government - the Reserve Bank monetised 59% of the domestic fiscal deficit in 1973/74 compared with 35% in 1970/71 - and sharply higher growth in both the monetary base and M1. The monetary base increased at an average annual pace of 15% between 1971 and 1974, compared with less than 5% annual growth in the period 1960-1969.

During the 1971-1974 period the cumulative growth in net Reserve Bank credit to the government exceeded that of the base as a whole. Thus one may conclude that the period of expansionary monetary growth was virtually entirely the result of a monetisation of a portion of the government's fiscal deficit. India's experience thus contrasts with that of many economies in the Asian Pacific Rim. Economies such as Japan, Australia and Singapore also experienced sharply higher monetary growth in 1971-73, but in each case the primary source was the growth in net foreign assets deriving from a cyclical surplus on balance of payments. However, a glance at Chart 1 indicates that the Reserve Bank's net foreign exchange holdings rose a negligible amount in the three years to 1973.

1974-1975: Monetary Restraint

During 1973, the Indian monetary authorities became increasingly alarmed about the high level of monetary growth and rising inflation. During the year a range of measures were implemented to try to stem the increase in banks' balance sheets. Selective controls were imposed on commercial bank credit to certain industrial sectors of the economy, whilst a wide variety of credit "norms" were established for remaining non-preferred sector borrowers. Finally, in the final quarter of 1973, total commercial bank growth credit ceilings were introduced and the Cash Reserve Ratio was raised from 3% to 7%.

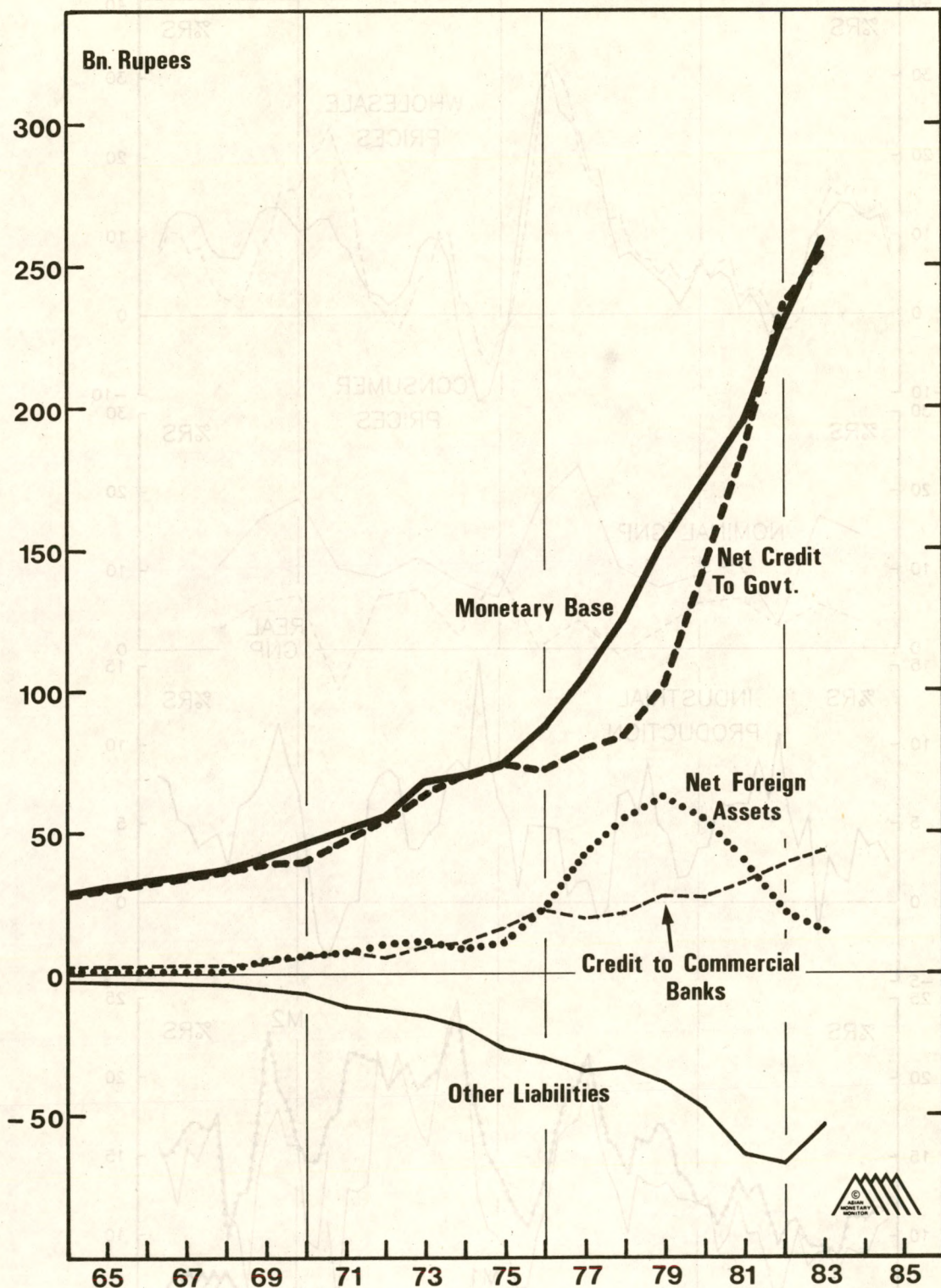
Monetary growth slowed somewhat during the first quarter of 1974, but whilst growth in the monetary base remained strong (refer to Chart 1) there could be little chance of this being sustained.

Effective monetary restraint was not implemented until the second half of 1974, when a package of deflationary measures were introduced, including a rise in the Reserve Bank's Discount Rate from 6% to 9% and a reduction in the central government's fiscal deficit. The increase in central bank regulated interest rates was accompanied by higher yields on official debt. This helped the Reserve Bank to reduce the proportion of the fiscal deficit which was monetised from 59% in 1973/74 to 37% in 1975/76. Reduced growth in net central bank lending to the government resulted in slower growth in the monetary base (see Chart 1) and a sharp decline in the growth of the wider monetary aggregates (see Chart 2). Restrained monetary conditions led ultimately to significantly lower inflation, with consumer prices falling by approximately 5% in the year to June 1976.

The salient feature of India's monetary experience in the years 1971 through 1976 is that the Reserve Bank's practice of targeting a specific category of commercial banks' assets proved singularly unsuccessful in determining growth in banks' balance sheets or in influencing the trend of domestic inflation. When, in late 1973, the Indian authorities sought to reduce substantially the level of inflation they were forced to turn to orthodox means - by curtailing growth in the monetary base - to restrain money and credit growth.

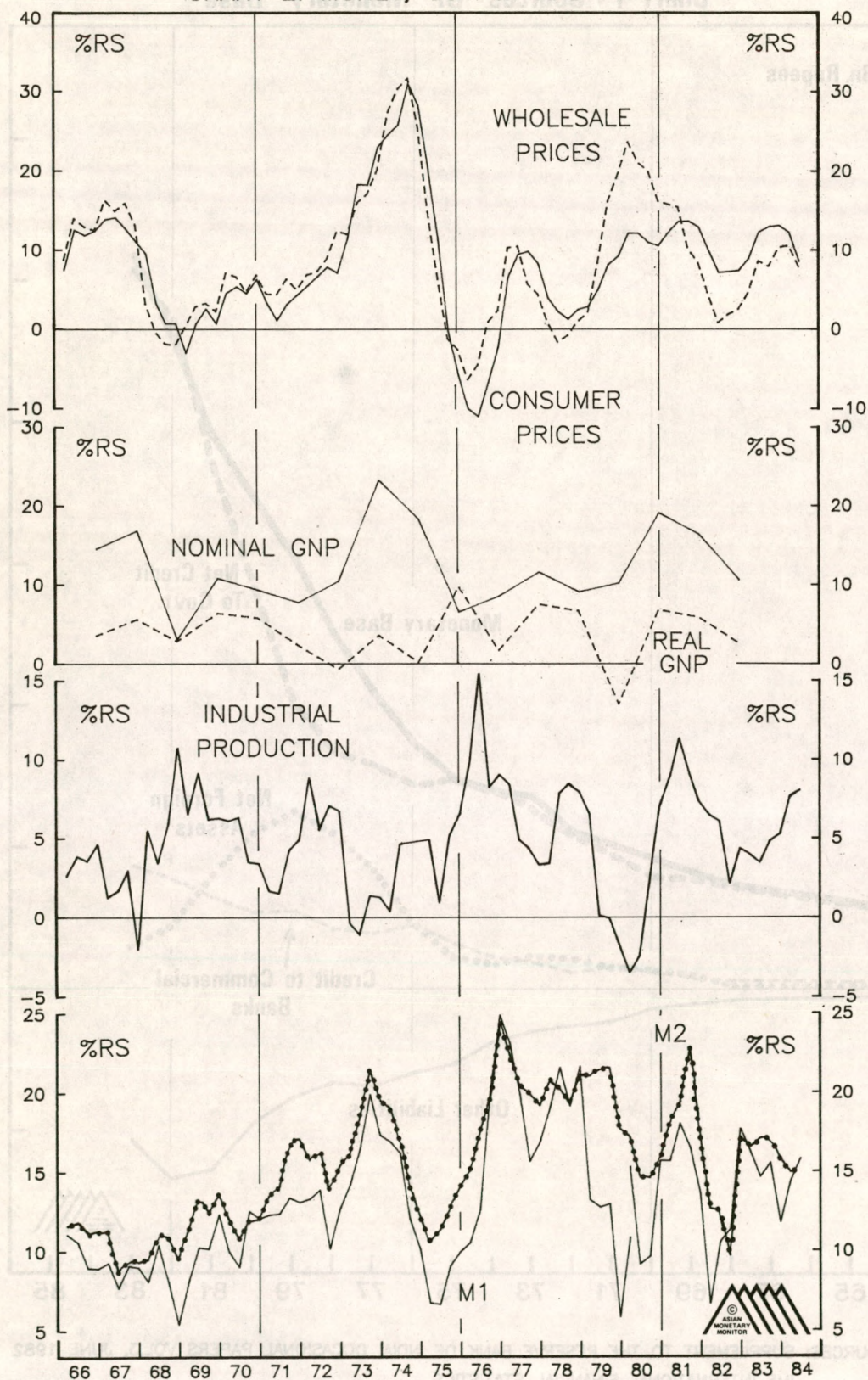
INDIA

Chart 1 : Sources Of Monetary Base



SOURCES: SUPPLEMENT TO THE RESERVE BANK OF INDIA, OCCASIONAL PAPERS VOL.3, JUNE 1982
IMF INTERNATIONAL FINANCIAL STATISTICS

INDIA
 CHART 2: MONEY, OUTPUT AND PRICES



1976-1979: Large External Surpluses Create Easy Domestic Monetary Conditions

Between the end of 1975 and the beginning of 1979 consumer prices in the Indian economy were basically unchanged. The improved competitiveness of the Indian economy, during a period of strong growth in world trade, encouraged improved growth in Indian exports in 1976 and 1977. In 1979, the value of Indian exports were 70% higher than in 1976. The strong export performance was mainly responsible for the creation of substantial current account surpluses in 1977 and 1978 which in turn led to a large increase in the net foreign assets component of the monetary base (see Chart 1) and a rise in monetary growth.

1980-1983: Unsuccessful Attempts to Restrain Monetary Growth

Although Indian inflation has been moderate over the last three years, by comparison with the 1972/74 period, the basic objective of monetary policy has been to restrain money and credit creation in order to dampen inflationary expectations. In its attempt to restrict the rate of growth of banks' balance sheets the Reserve Bank, as in 1973/74, has targeted successive reductions in the annual increase in commercial banks' non-food credit and raised the Cash Reserve Ratio to 9% in 1982. However, growth in non-food commercial bank credit measured 17% in both 1982 and 1983, despite an increase in the Discount Rate, to 10%, and M1 growth averaged 14.6%, annually, over the period.

The reason monetary policy has been more lax than the Reserve Bank had intended is that the Indian monetary authorities have been unable - or unwilling - to restrict the growth of the monetary base. Reserve Bank net credit to the government has soared 150% (see Chart 1) since 1979, swamping a decline in the net foreign exchange holdings source of the base, and this has been wholly responsible for an average 14.5% annual increase in the base over the last four years. Until such time as the Indian authorities act concertedly to reduce excessive growth in the base, monetary growth will continue at a high level, risking rising inflation.

Conclusion

The Indian monetary authorities lack the means for effective medium-term control over money and credit growth in the domestic economy. In practice, the rate of growth of the monetary base is determined by the central government's fiscal strategy as the Reserve Bank has been obliged to monetise a large and generally rising proportion of the Commonwealth government's fiscal deficit. In theory, the Reserve Bank could offset its increased net lending to the government by reducing its claims upon the local banking system or by managing the external value of the Rupee so as to encourage an overall balance of payments deficit. In practice, the effective use of both these options is heavily constrained by the perceived need to ensure that bank credit is readily and cheaply available to certain borrowers.

Effective control over money and credit growth in India lies with the central government rather than with the Reserve Bank. Over the medium term the Reserve Bank cannot exercise effective independent restraint in the face of "expansionary" government fiscal policies. Nevertheless, the history of the 1970s is moderately reassuring. When faced with excessive monetary growth and rising inflation during 1973 and 1974, the Indian authorities did exercise orthodox measures of restraint: the Indian government reduced its fiscal deficit, raised interest rates and slowed growth in the monetary base. During the period 1971-1980, India's inflation record compared favourably with that in the US. India's consumer price index rose at an average annual rate of 8.5% over the period, compared with 8.4% in the US.

Since 1980, the Reserve Bank's stated policy has been to restrict the availability of credit and money to the domestic economy. The Reserve Bank has not succeeded in this objective because it has proved unable, or unwilling, to restrict growth in the monetary base. The recent rapid increases in reserve money must soon be reversed if India is not to have its international reputation for financial conservatism tarnished.

MALAYSIA

THE MONETARY CONSEQUENCES OF FISCAL 'AUSTERITY'

As was widely expected, the recently announced Malaysian budget for 1985 continued the trend towards expenditure restraint which has been in evidence in Malaysian budgets since the first cutbacks in development spending in mid-1982. Since that time development expenditure has been gradually reduced in an effort to reverse the highly expansionist fiscal policies which had been in place between 1980 and 1982, and control Malaysia's burgeoning external debt.

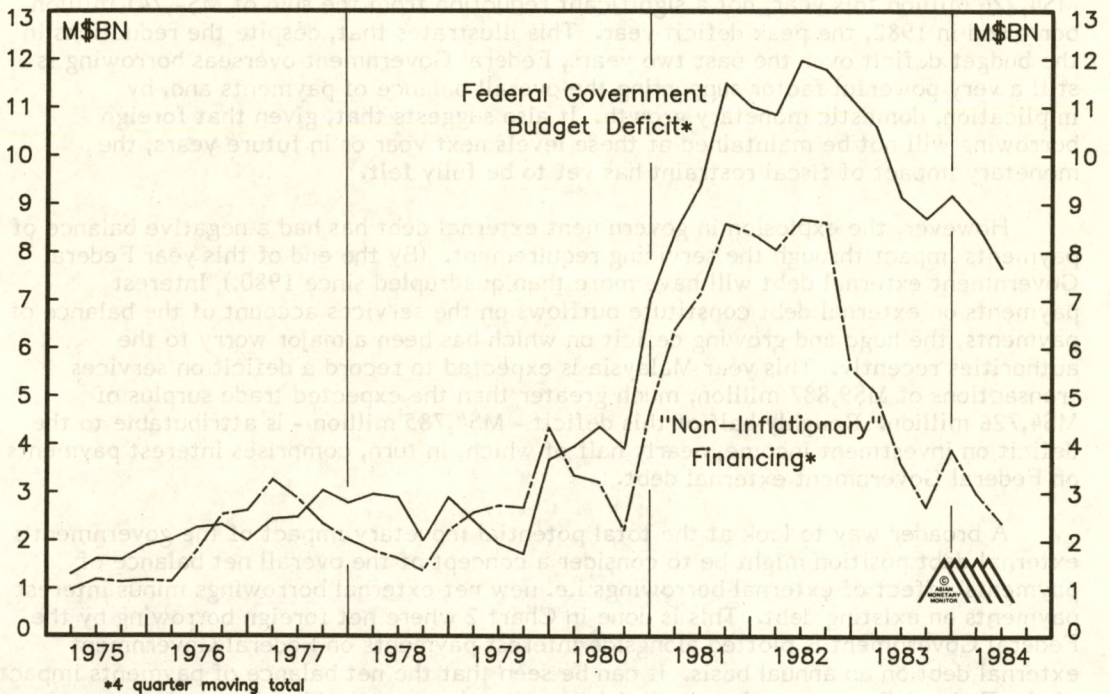
Malaysia's fiscal strategy was effectively laid out in last year's budget (for 1984) when then Finance Minister Tunku Razaleigh Hamzah projected that the federal government's deficit as a proportion of GNP would be reduced from 19% in 1982 to 15% in 1983, 10.8% in 1984 and "about 6%" in 1985. In the event, progress so far has not quite lived up to those expectations. Overruns in both operating and development expenditure have meant that the federal government deficit this year is expected to reach M\$8,447 million, or 11.8% of the GNP. However, sharp cutbacks in development expenditure projected in the budget for 1985 mean that the deficit is now budgeted to be reduced to M\$6,324 million, or 8.3% of the GNP next year. If achieved, this would represent a near halving of the deficit from its 1982 peaks, and as such it is appropriate to assess the monetary implications of this, and likely future deficit reductions.

Chart 1 depicts, on a quarterly basis, a four quarter moving total of the Federal Government deficit and that part of the deficit which is financed in a 'non-inflationary' manner, by which is meant, essentially, bond sales to the Employees Provident Fund and financial institutions, as well as drawdowns of Trust Fund balances. The residual financing, represented by the space between the two lines on the chart, is then taken as being 'inflationary'. 'Inflationary' financing is here interpreted in a very broad sense to include not only net bond purchases by the Central Bank (i.e. direct monetisation of the deficit) but also external borrowing by the government. The rationale for including external borrowing is that, given Malaysia's rigidly managed exchange rate, official capital inflows will, all other things being equal, lead to an increase in the Central Bank's net foreign assets, the counterpart to which may initially be an increase in government deposits at the Central Bank, but ultimately will be an increase in the monetary base.

Chart 1, which includes data to the second quarter of 1984, highlights an important fact - namely, that although the budget deficit has been reduced significantly over the last two years the monetary stimulus arising from deficit financing has not been so reduced, purchases of government debt by domestic institutions other than the Central Bank and asset drawdowns having instead declined in tandem with the deficit. This is at first sight quite surprising given that the main domestic purchaser of government debt is the Employees Provident Fund (EPF) and its demand for government debt grows steadily in line with the increase in net contributions to the Fund. The explanation lies partly with the sharp decline in bond purchases by the Commercial Banks since 1982. In 1982, commercial banks subscribed M\$2,503 million, or 40%, of government bonds issued, the bulk of this massive subscription being for the end-May government issue. In 1984, commercial banks have subscribed only M\$371 million to Federal Government bond issues which means that, after redemptions of M\$122 million, their net financing of the government's deficit amounts to only M\$249 million this year. This trend has been reflected in commercial banks' holdings of government securities as a proportion of their total deposits, the ratio having fallen from 20.9% at the peak in August 1982 to 8.9% by July of this year.

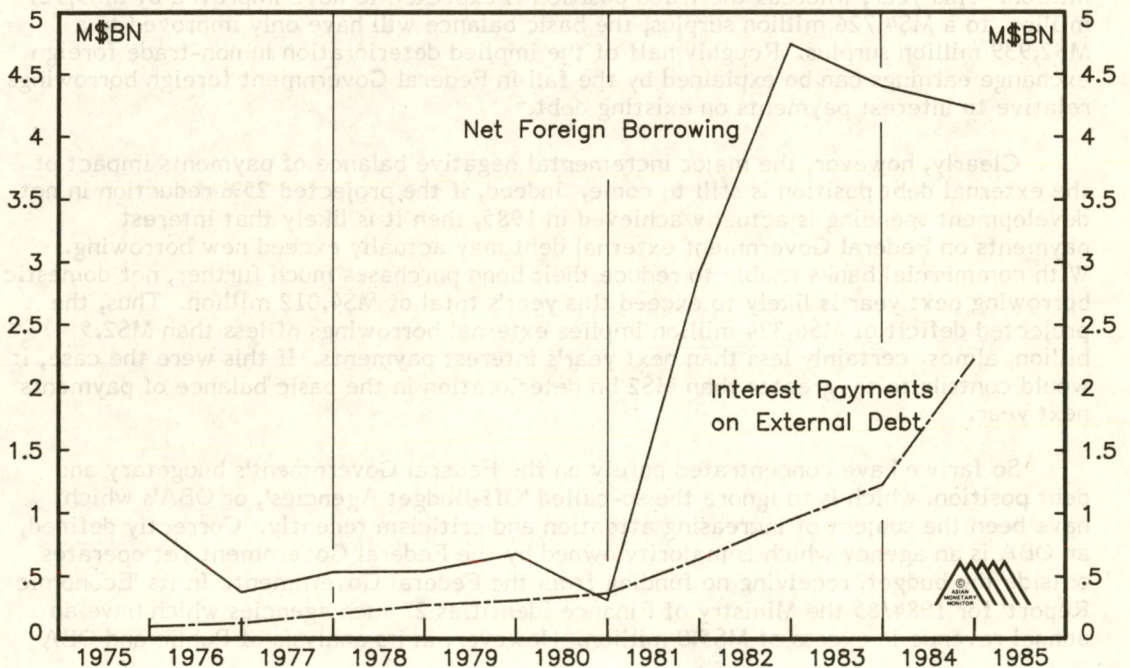
MALAYSIA

CHART 1: THE FINANCING OF THE BUDGET DEFICIT



MALAYSIA

CHART 2: FEDERAL GOVERNMENT EXTERNAL BORROWING AND DEBT SERVICE



The marked reduction in commercial bank lending to the government since 1982 has been mirrored in the much greater proportion of the budget deficit which has been financed from overseas. Federal Government net foreign borrowing is expected to total M\$4,226 million this year, not a significant reduction from the sum of M\$4,741 million borrowed in 1982, the peak deficit year. This illustrates that, despite the reductions in the budget deficit over the past two years, Federal Government overseas borrowing is still a very powerful factor supporting the overall balance of payments and, by implication, domestic monetary growth. It also suggests that, given that foreign borrowing will not be maintained at these levels next year or in future years, the monetary impact of fiscal restraint has yet to be fully felt.

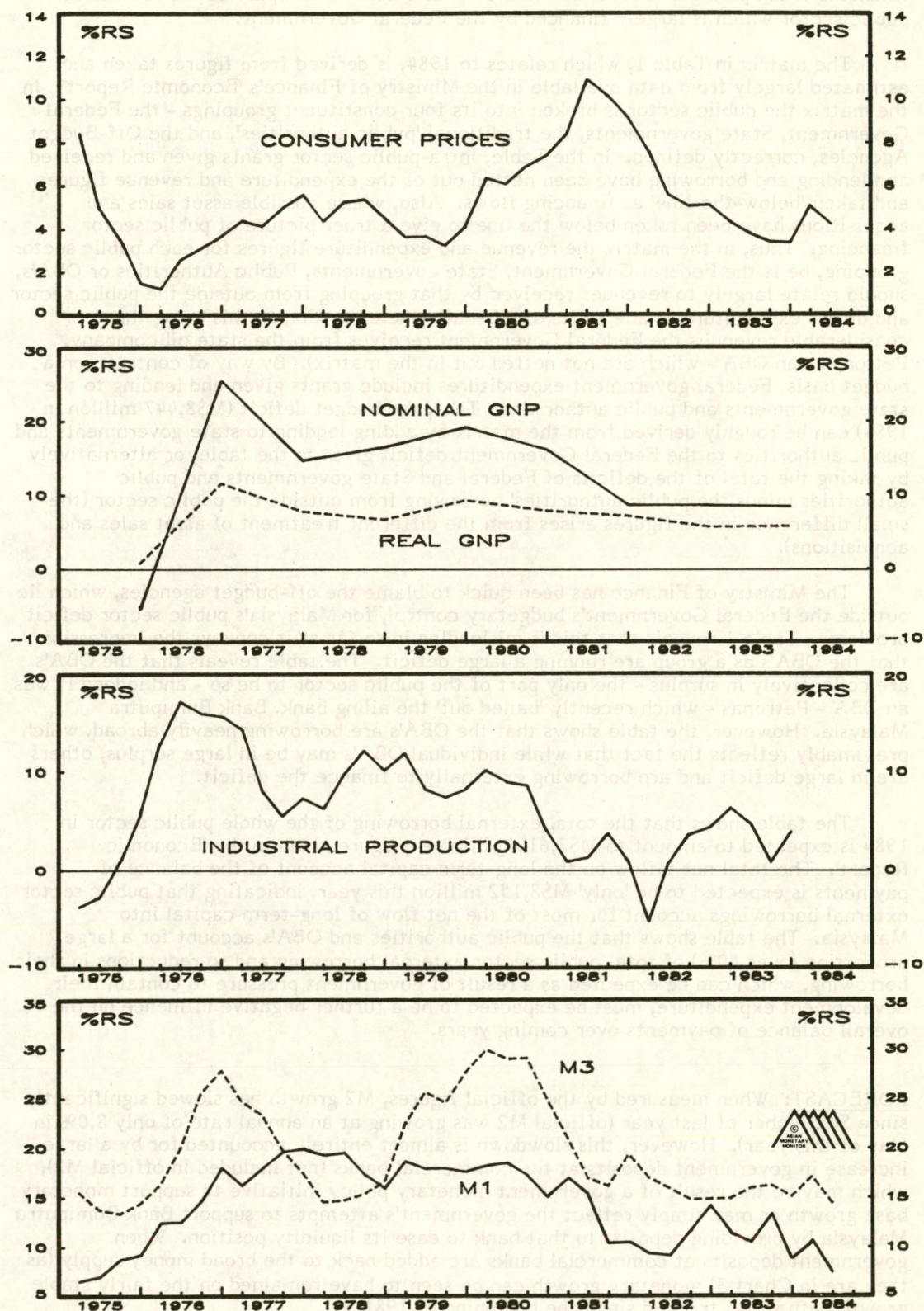
However, the explosion in government external debt has had a negative balance of payments impact through the servicing requirement. (By the end of this year Federal Government external debt will have more than quadrupled since 1980.) Interest payments on external debt constitute outflows on the services account of the balance of payments, the huge and growing deficit on which has been a major worry to the authorities recently. This year Malaysia is expected to record a deficit on services transactions of M\$9,887 million, much greater than the expected trade surplus of M\$4,726 million. Roughly half of this deficit - M\$4,785 million - is attributable to the deficit on investment income, nearly half of which, in turn, comprises interest payments on Federal Government external debt.

A broader way to look at the total potential monetary impact of the government's external debt position might be to consider a concept of the overall net balance of payments' effect of external borrowings i.e. new net external borrowings minus interest payments on existing debt. This is done in Chart 2 where net foreign borrowing by the Federal Government is plotted alongside interest payments on Federal Government external debt on an annual basis. It can be seen that the net balance of payments impact of the Federal Government's overall debt position (represented by the gap between the two lines on the chart) has contracted significantly from its peak, in 1982. In 1982 new borrowing exceeded interest payments by M\$3.79 billion whereas in 1984 the difference should be M\$2 billion. To set this against the overall balance of payments background, in 1982 Malaysia's merchandise trade was in deficit by M\$1,199 million whereas the basic balance (balance on trade, services and long-term capital) was in surplus by M\$812 million. This year, whereas the trade position is expected to have improved by M\$5,925 million, to a M\$4,726 million surplus, the basic balance will have only improved to a M\$2,939 million surplus. Roughly half of the implied deterioration in non-trade foreign exchange earnings can be explained by the fall in Federal Government foreign borrowings relative to interest payments on existing debt.

Clearly, however, the major incremental negative balance of payments impact of the external debt position is still to come. Indeed, if the projected 25% reduction in net development spending is actually achieved in 1985, then it is likely that interest payments on Federal Government external debt may actually exceed new borrowing. With commercial banks unable to reduce their bond purchases much further, net domestic borrowing next year is likely to exceed this year's total of M\$4,012 million. Thus, the projected deficit of M\$6,324 million implies external borrowings of less than M\$2.5 billion, almost certainly less than next year's interest payments. If this were the case, it would contribute to greater than M\$2 bn deterioration in the basic balance of payments next year.

So far we have concentrated purely on the Federal Government's budgetary and debt position, which is to ignore the so-called 'Off-Budget Agencies', or OBA's which have been the subject of increasing attention and criticism recently. Correctly defined, an OBA is an agency which is majority owned by the Federal Government yet operates outside the budget, receiving no funding from the Federal Government. In its 'Economic Report' for 1984/85 the Ministry of Finance identifies 27 such agencies which have an annual revenue in excess of M\$5.0 million. However, in its analysis of Public and OBA

MALAYSIA
CHART 3: MONEY, OUTPUT AND PRICES



financing it lumps these 'OBA's' with the 14 public authorities, part of the 'traditional' public sector which is largely financed by the Federal Government.

The matrix in Table 1, which relates to 1984, is derived from figures taken and estimated largely from data available in the Ministry of Finance's 'Economic Report'. In the matrix the public sector is broken into its four constituent groupings - the Federal Government, State governments, the traditional 'public authorities', and the Off-Budget Agencies, correctly defined. In the Table, intra-public sector grants given and received and lending and borrowing have been netted out of the expenditure and revenue figures and taken 'below-the-line' as financing flows. Also, where possible asset sales and acquisitions have been taken below the line to give a truer picture of public sector financing. Thus, in the matrix the revenue and expenditure figures for each public sector grouping, be it the Federal Government, State governments, Public Authorities or OBA's, should relate largely to revenues received by that grouping from outside the public sector and direct expenditures made on its own behalf (one exception to this being the considerable revenues the Federal Government receives from the state oil company, Petronas - an OBA - which are not netted out in the matrix). By way of contrast, on a budget basis, Federal government expenditures include grants given and lending to the state governments and public authorities. Thus, the budget deficit (M\$8,447 million in 1984) can be roughly derived from the matrix by adding lending to state governments and public authorities to the Federal Government deficit given in the table, or alternatively by taking the total of the deficits of Federal and State governments and public authorities minus the public authorities' borrowing from outside the public sector (the small difference in the figures arises from the different treatment of asset sales and acquisitions).

The Ministry of Finance has been quick to blame the off-budget agencies, which lie outside the Federal Government's budgetary control, for Malaysia's public sector deficit problems. Table 1 reveals that this is misleading in so far as it conveys the impression that the OBA's as a group are running a large deficit. The table reveals that the OBA's are collectively in surplus - the only part of the public sector to be so - and indeed it was an OBA - Petronas - which recently 'bailed out' the ailing bank, Bank Bumiputra Malaysia. However, the table shows that the OBA's are borrowing heavily abroad, which presumably reflects the fact that while individual OBA's may be in large surplus, others are in large deficit and are borrowing externally to finance the deficit.

The table shows that the total external borrowing of the whole public sector in 1984 is expected to amount to M\$7,610 million - a figure given in the 'Economic Report'. The total net inflow on the long-term capital account of the balance of payments is expected to be 'only' M\$8,152 million this year, indicating that public sector external borrowings account for most of the net flow of long-term capital into Malaysia. The table shows that the public authorities and OBA's account for a large proportion (over 40%) of total public sector external borrowing and so reductions in their borrowing, which can be expected as a result of government pressure to contain their development expenditure, must be expected to be a further negative influence on the overall balance of payments over coming years.

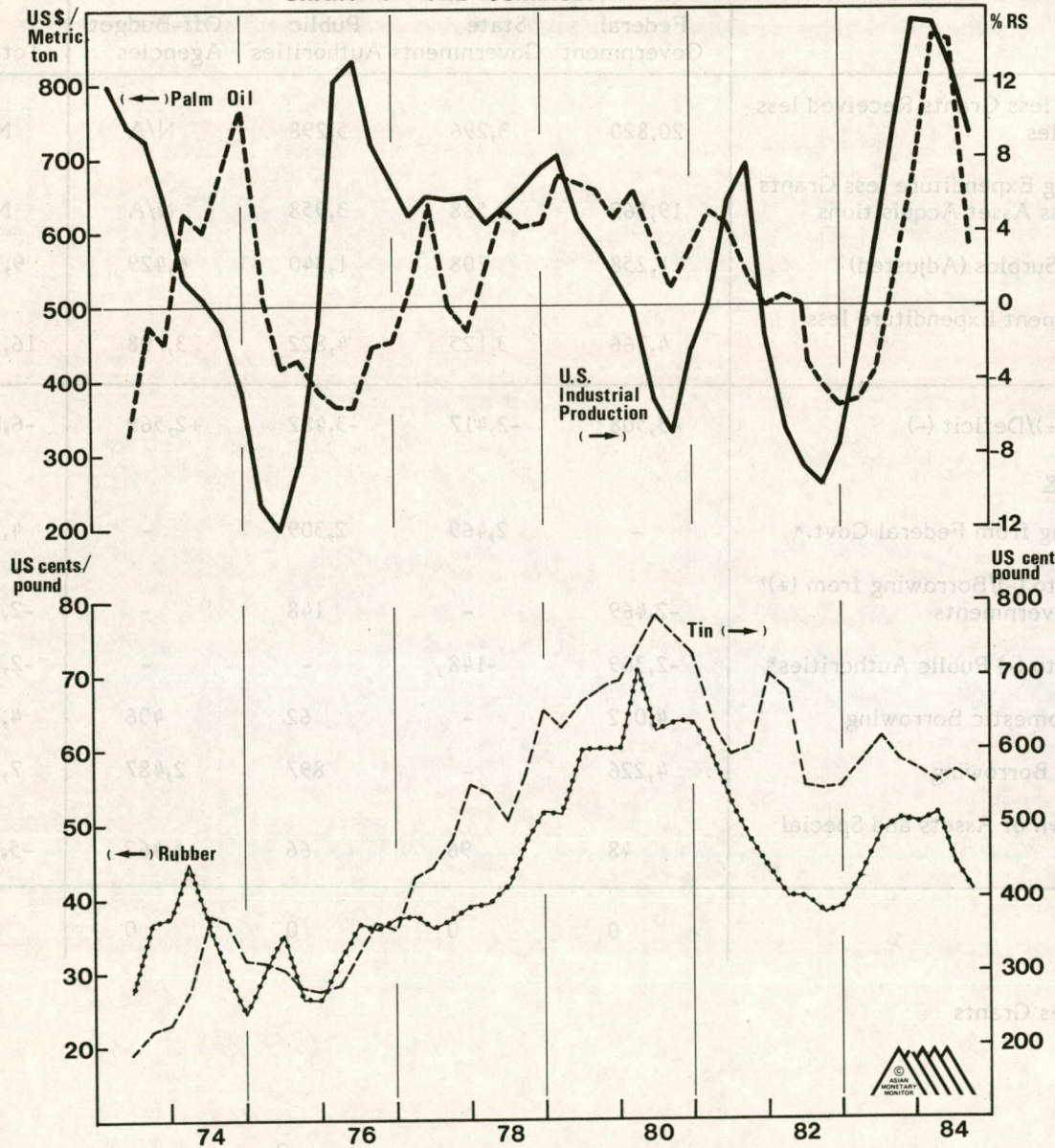
FORECAST: When measured by the official figures, M2 growth has slowed significantly since September of last year (official M2 was growing at an annual rate of only 8.0% in May of this year). However, this slowdown is almost entirely accounted for by a large increase in government deposits at the commercial banks (not included in official M2), which may be the result of a government monetary policy initiative to support monetary base growth or may simply reflect the government's attempts to support Bank Bumiputra Malaysia by providing deposits to that bank to ease its liquidity position. When government deposits at commercial banks are added back to the broad money supply (as they are in Chart 3) monetary growth can be seen to have remained on the fairly stable growth path it has tracked since the beginning of 1981.

TABLE 1
FINANCING OF THE PUBLIC SECTOR, 1984

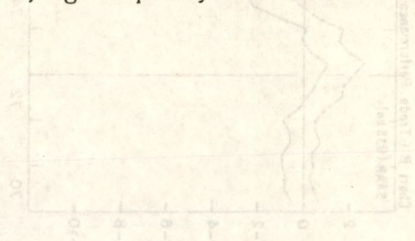
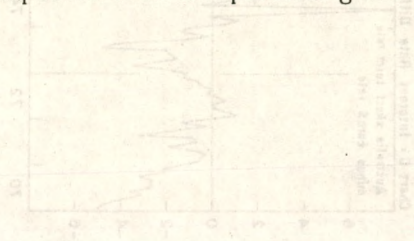
	M\$Million				
	Federal Government	State Governments	Public Authorities	Off-Budget Agencies	Total
Revenue less Grants Received less Asset Sales	20,820	3,296	5,298	N/A	N/A
Operating Expenditure less Grants Given less Asset Acquisitions	19,562	2,588	3,958	N/A	N/A
Current Surplus (Adjusted)	1,258	708	1,340	6,429	9,735
Development Expenditure less Loans	4,766	3,125	4,822	3,798	16,511
Surplus (+)/Deficit (-)	-3,508	-2,417	-3,482	+2,569	-6,838
Financing					
Borrowing from Federal Govt.*	-	2,469	2,309	-	4,778
Lending to (-)/Borrowing from (+)* State Governments	-2,469	-	148	-	-2,321
Lending to (-) Public Authorities*	-2,309	-148	-	-	-2,457
Other Domestic Borrowing	4,012	-	62	406	4,480
External Borrowing	4,226	-	897	2,487	7,610
Drawdown of Assets and Special Receipts	48	96	66	-5,462	-5,252
Total	0	0	0	0	0

* Includes Grants

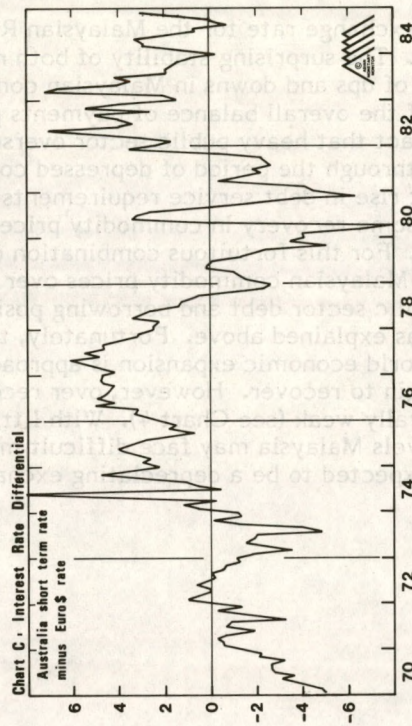
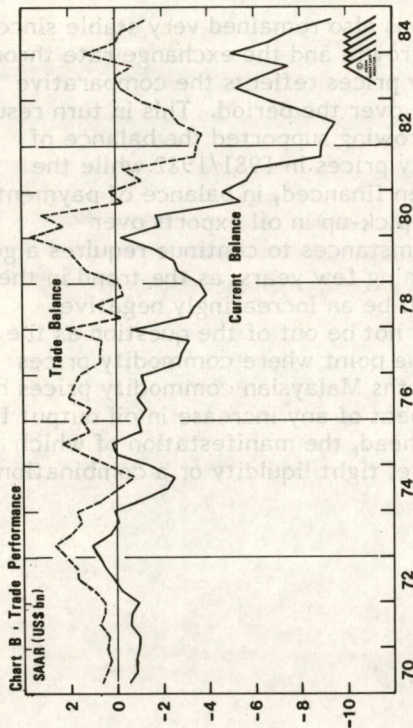
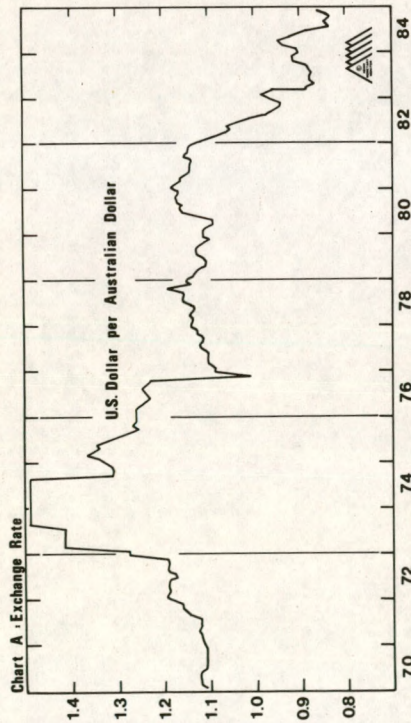
MALAYSIA
CHART 4: THE COMMODITY PRICE CYCLE



The exchange rate for the Malaysian Ringgit has also remained very stable since early 1981. The surprising stability of both money growth and the exchange rate through four years of ups and downs in Malaysian commodity prices reflects the comparative stability of the overall balance of payments position over the period. This in turn results from the fact that heavy public sector overseas borrowing supported the balance of payments through the period of depressed commodity prices in 1981/1982 while the subsequent rise in debt service requirements has been financed, in balance of payments terms, by some recovery in commodity prices and a pick-up in oil exports over 1983/1984. For this fortuitous combination of circumstances to continue requires a good uptrend in Malaysian commodity prices over the coming few years, as the trend in the overall public sector debt and borrowing position will be an increasingly negative influence as explained above. Fortunately, this may not be out of the question as the cycle of world economic expansion is approaching the point where commodity prices usually begin to recover. However, over recent months Malaysian commodity prices have been generally weak (see Chart 4). With little prospect of any increase in oil output from current levels Malaysia may face difficult months ahead, the manifestation of which could be expected to be a depreciating exchange rate, tight liquidity or a combination of both.



AUSTRALIAN DOLLAR



Since the beginning of July the Australian dollar has traded in a narrow range, US\$0.8250-US\$0.8650, against the US dollar. The Australian dollar's recent stability against the US dollar represents considerable relative strength against other currencies. The US dollar effective exchange rate has risen by more than 12% since mid-year, and the Australian dollar has appreciated by nearly 10% against many European currencies.

It is hard to account fundamentally for the relative strength of the Australian dollar in recent months. The Reserve Bank has pursued an effectively easy monetary policy - which is typically associated with a weaker trend in the external value of a currency - since mid-year, both in relation to its prior policy and relative to policy in the US (see Chart E). M1 growth has exceeded 16%, annualised, since the end of June, whilst M3 has recorded an annual growth rate of 14% over the period. M3 is therefore considerably above its official 1984/85 growth target of 8%-10%.

An accommodative domestic monetary policy has encouraged further strong growth in the domestic economy which is now being reflected in a surge in demand for imported goods and services. During the third quarter Australia's import bill rose 24.6% from the third quarter of 1983, compared with a 7.8% decline in total imports last year. This sharp increase in import demand has led to a return to deficits on trade account (see Chart B) and,

together with substantially enlarged deficits on Australian net "invisibles" account, a substantial deterioration in the current account. Australia's recent current account deficits have rivalled the prior record shortfalls of the first half of 1982 and are a medium term source of concern to investors in the Australian dollar.

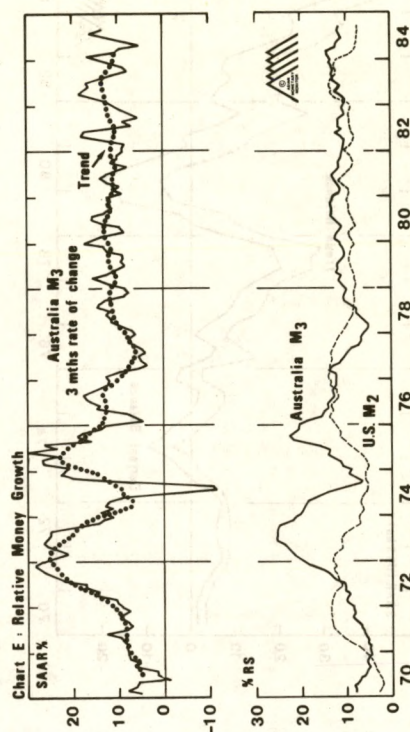
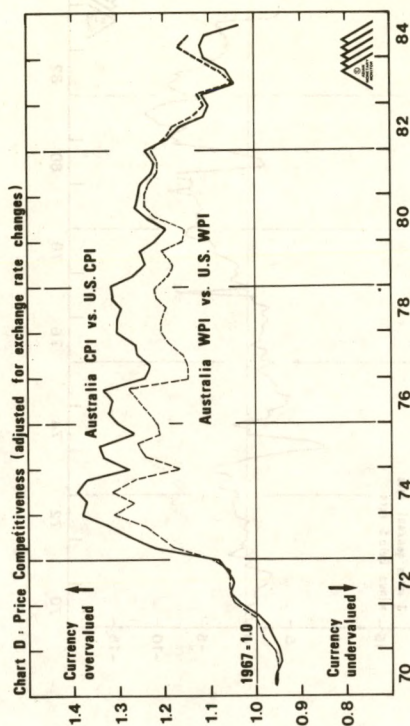
Although recent monetary and current account trends argue for a bearish outlook on the Australian dollar, investors cannot ignore the importance of other influences on currency trends. In particular, the Labour government's success in reducing inflation, (consumer prices, as measured, rose 3.8% in the year to September) reducing unemployment and curbing Trades Union militancy has engendered considerable domestic confidence in their management of the economy. This, together with a favourable short term interest rate differential, (Chart C) must have encouraged overseas investors willingly to acquire claims on the Australian economy and thus to "finance" Australia's current account deficit at the current exchange rate.

For the time being, with measured inflation likely to remain low, it is probably that overseas confidence in Australia's macro-economic management policies will remain firm. The Australian dollar may therefore continue to trade strongly on the foreign exchanges, especially as local short rates are likely to rise into the local tax payment period in March/April 1985. However, investors should soon start to anticipate a cyclical rise in Australian inflation - the result of two years of accommodative monetary policies. Unless the Reserve Bank acts swiftly to subdue monetary growth and hence to limit future inflationary pressures, confidence in the Australian economy and its currency will likely decline.

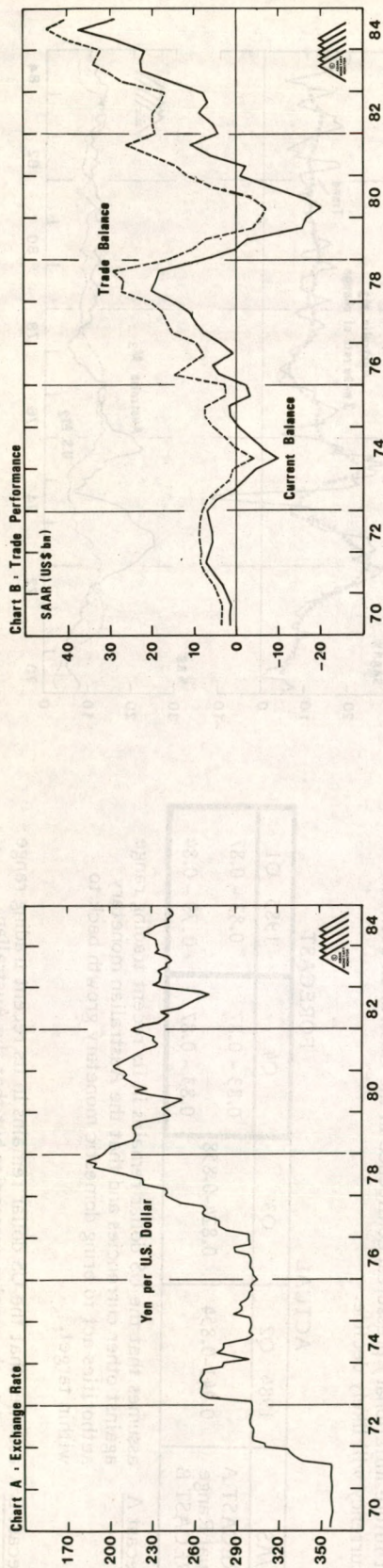
US\$/A\$	ACTUAL		FORECAST	
	1984	Q2	Q3	Q4
FORECAST A				1985 Q1
Actual Range				0.83 - 0.87
FORECAST B				0.79 - 0.84

Forecast A assumes that the US dollar remains in its recent trading range against other currencies and that the Australian monetary authorities act to bring domestic monetary growth back to within target.

Forecast B assumes that the US dollar remains in its recent trading range against other major currencies but that the Australian authorities continue to allow rapid growth in the domestic money supply next year.



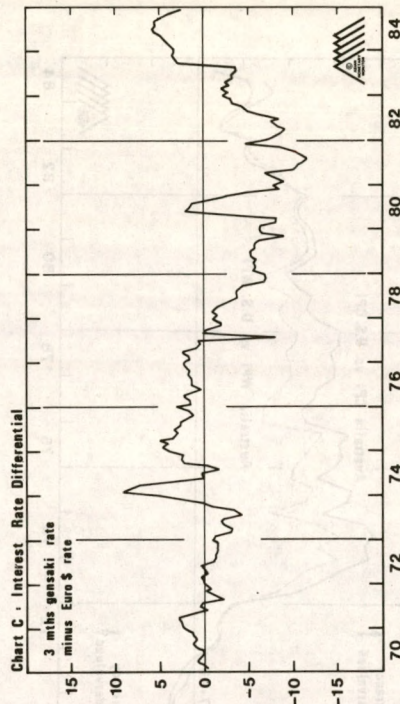
JAPANESE YEN



Compared with the DM and sterling which are also floating against the US\$, the Japanese yen has remained in a quite limited 10-12% trading range against the US\$ during the first nine months of the year (221-248), though it has risen strongly against sterling and the DM.

Despite the strong performance of Japan's trade balance and its current account which recorded surpluses of US\$11.5 billion and US\$7.3 billion respectively in the July-September quarter (Chart B), and the continuing low rate of inflation (the CPI rose 2.3% year-to-year in the same quarter), the yen has performed disappointingly. Having appreciated to an index value of 157.5 in March, the real effective exchange rate index (Chart D) had declined to 145.9 at the end of September. On a nominal trade-weighted basis the yen has remained virtually unchanged over the year, and it is only against the US\$ that it has been weak.

Although the inflation rate in the USA has not risen as much as we had previously expected, Japan's relative price competitiveness has continued to improve, making the currency increasingly undervalued against the US dollar. While this has boosted Japan's trade performance, it is likely that Japan's trade surpluses will soon be reaching a cyclical peak for several reasons. First, it is really only Japan's exports to the USA which have risen strongly during this recovery, and the competitive position of the yen has only improved against the US dollar. Conversely, because the yen has generally



appreciated against European and other currencies and their recoveries have been more muted than the upswing in the US, if and when exports to the US slow down there is unlikely to be much taking up of slack by the growth of other areas. Also, as Japan's domestic economy gradually picks up, imports are likely to increase, though not dramatically as long as commodity prices (and especially oil) remain on a downward path and the domestic economy remains on a stable course.

In the second and third quarters the capital account recorded huge net "outflows" (mainly net increases in foreign assets held by Japanese residents) of US\$14.3 billion and US\$12.5 billion respectively. Japan is thus becoming a classical capital exporter. These enormous "outflows" are of course the counterpart of the surpluses on trade and current account, and each is sustainable as long as the other continues.

If either abruptly ceases, there will be an immediate adjustment in the level of the yen, followed by a compensating shift in the capital or current account until equilibrium is restored. Insofar as Japan's capital account is concerned, the primary factor producing the deficit is the perceived real interest rate differential between the US and Japan which, assuming no domestic policy change in Japan, can only be reduced by a decline in US real interest rates, which in turn requires either lower nominal interest rates or a higher US inflation rate. Insofar as Japan's trade and current accounts are concerned, the determinants are more dispersed, and hence any changes are unlikely to be as rapid as on the capital account. Given that Japan has a floating exchange rate, the capital and current accounts must balance over time, and it follows from the argument above that the current account must adjust to finance the capital account. Any sudden abatement of the net capital outflow could thus be expected to lead to yen appreciation, followed by some compensating reduction in the current account surplus. Conversely any increase in the capital outflow, could be expected to lead initially to yen depreciation followed by a compensating increase in the current account surplus - even from present levels.

Yen/US\$	ACTUAL			FORECAST	
	1984	Q2	Q3	Q4	1985 Q1
FORECAST A					
Actual Range	223.4-238.8		238.8-247.5	235-250	225-240
FORECAST B				240-255	240-260

Forecast A assumes that a slowdown in the US brings lower US\$ interest rates.

Forecast B assumes that US economic activity remains strong and US\$ interest rates remain steady or rise.

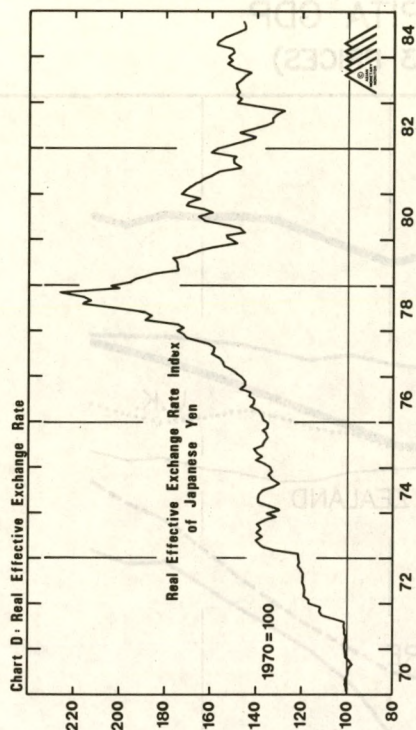


Chart D: Real Effective Exchange Rate of Japanese Yen. The Real Effective Exchange Rate Index is a trade-weighted index of the exchange rate against 8 currencies, adjusted for differential consumer price changes.

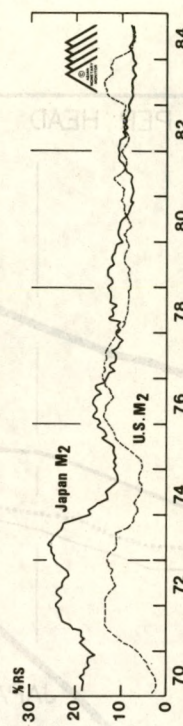
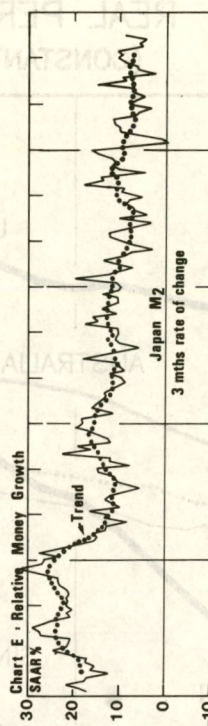
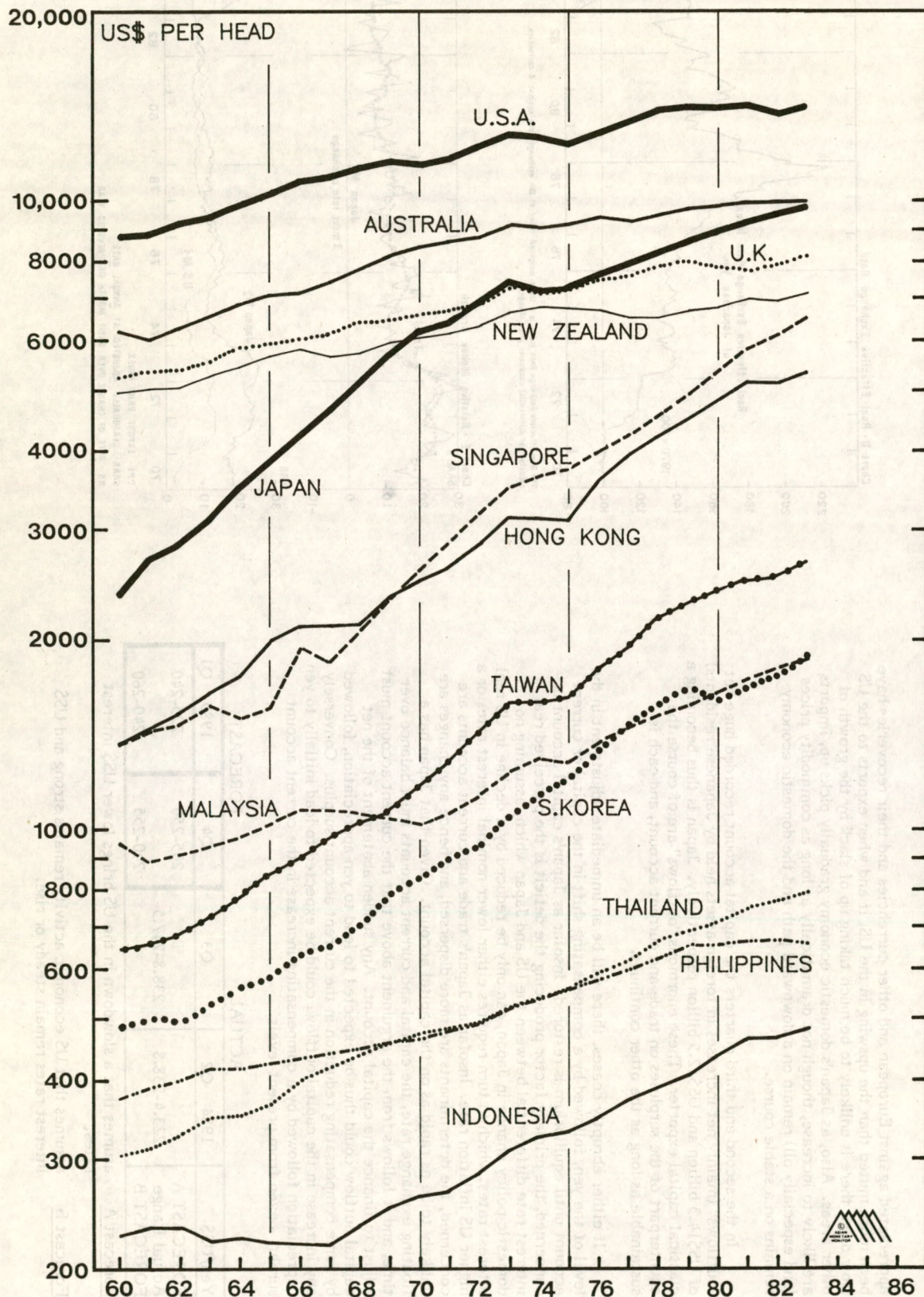


Chart E: Relative Money Growth. SAAR%: SEASONALLY ADJUSTED AT ANNUAL RATE. RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR.

REAL PER CAPITA GDP (CONSTANT 1983 PRICES)

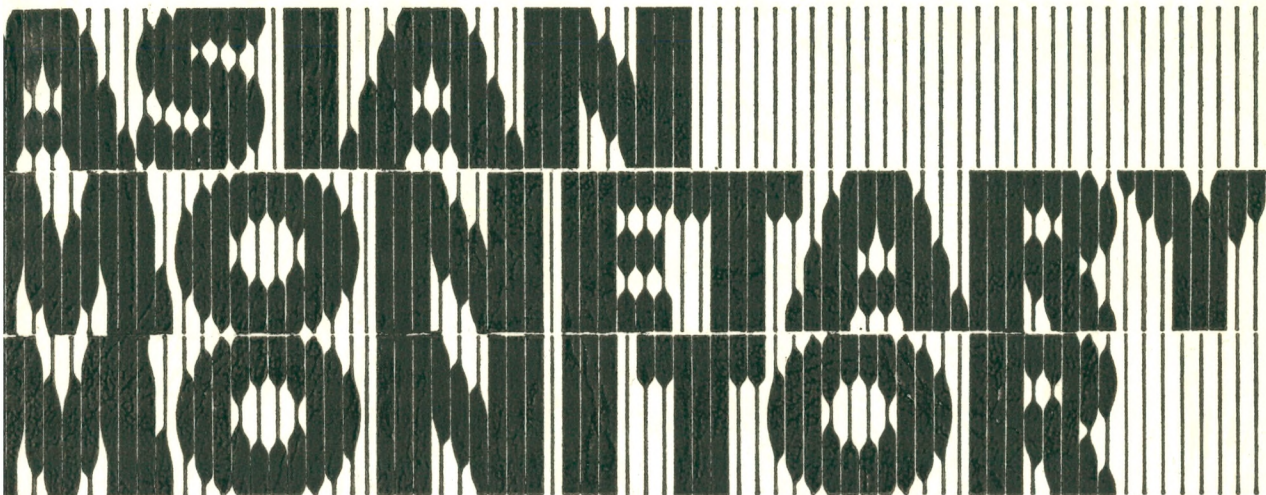




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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

HONG KONG

WHY THE HK\$/US\$ LINKED RATE SYSTEM SHOULD NOT BE CHANGED

Following the signing of the Joint Sino-British Agreement on the Future of Hong Kong, there have been several suggestions that it is time to reconsider the linked rate system for the HK\$ which was introduced in October 1983. An implicit theme of bankers and other commentators who propose altering the linked rate is that the system was introduced at a time of crisis, and, since the crisis has now passed, the system has outlived its usefulness. This paper will consider first the economic benefits which the linked rate system for the HK\$ dollar has brought to the people of Hong Kong, and second the three principal proposals which have been made to amend or replace the current system.

The restoration of sound currency arrangements for Hong Kong has meant that the HK\$ can once again be relied on as a stable store of value and it can act as an efficient medium of exchange. The benefits which the stabilisation of the local currency has brought can be characterised in general terms in several ways: a reduction in uncertainty or information costs, lower transaction costs, and the elimination of arbitrary transfers between debtors and creditors (borrowers and lenders) due to unforeseen inflation. More specifically, three obvious benefits have been achieved:

The first major benefit is the reduction in inflation resulting from the stabilization of the currency. The inflation rate in Hong Kong has been much lower than it might otherwise have been in the wake of the currency panic of September 1983. At that time the year-to-year increase in consumer prices was close to 10%, though for a few days during the currency collapse there were signs of an incipient hyperinflation. Since the crisis the inflation rate in Hong Kong has declined markedly, and is gradually converging towards the inflation rate of the United States. (Taking a simple average of the three Consumer Price Indices, prices in Hong Kong have risen only 4.6% in the year since October 1983, while consumer prices in the USA have risen 4.2% over the same period.) For the Hong Kong consumer the purchasing power of the dollar in his pocket has been more stable in the past year than in any of the preceding seven years (since 1977). For the businessman, the attainment of price stability has meant a much more stable environment for costs which has assisted in planning for the future.

Second, because the vast majority of Hong Kong's trade is priced in US\$ and the HK\$/US\$ rate has been stable within very narrow limits since October 1983, every exporter and importer, every corporate treasurer, and hence every employee of all the companies involved in import/export trade have benefited from the linked rate for the HK\$.

Third, the ordinary man-in-the-street who holds his savings in Hong Kong banks or deposit-taking companies has benefited because, in contrast to the situation prevailing in Hong Kong before the introduction of the linked rate system, he now obtains a rate of interest which is higher than the annual rate of inflation. There is growing evidence from a variety of economic studies that the provision of competitive real returns to savers improves the allocation of resources, encourages investment and discourages wasteful speculation in assets which are primarily hedges against inflation. In linking the HK\$ to the US\$ and thereby bringing free market HK\$ interest rates closely into line with US\$ interest rates, many of the benefits of recent financial innovation and financial deregulation in the United States have been brought to Hong Kong at a stroke.

These benefits are very large and substantial. They have accrued, directly or indirectly, to virtually every individual in Hong Kong. At the same time there have also been costs under the new linked rate system, but these costs are either the unavoidable side effects of political uncertainty, or the consequences of certain technical features of the linked rate system which could in fact be alleviated.

One undoubted cost has been the greater variability of short-term interest rates under the linked rate system. Under the current mechanism political uncertainty can lead to a capital outflow (i.e. an external drain), which produces higher interest rates in the first instance as a step towards reducing the money supply. (See AMM, Jan.-Feb. 1984: "The Operation of the New Exchange Rate Mechanism" pp.4-5.) However, this greater variability of interest rates has to be considered against the alternative. Given the political uncertainties and the associated capital outflows which have confronted Hong Kong over the past two years, and which will no doubt recur from time to time in the future, the choice facing the Hong Kong authorities was between the floating rate system which was acutely vulnerable to adverse changes in sentiment and exposed every holder of HK\$ to the risk of currency depreciation, and the linked rate system which has proved capable of absorbing every disturbance to date in short term movements of interest rates, usually returning to equilibrium after a period of a few days.

Under a floating exchange rate system with no central bank there can be little doubt that Hong Kong would have been subject to a higher degree of volatility in its exchange rate and hence in its domestic price level than has actually occurred since October 1983. Under the linked rate system, by contrast, the exchange rate and the domestic price level remain largely stable, and those who are willing to hold HK\$ at times of political anxiety get rewarded with high rates of interest, while those who deliberately establish HK\$ liability positions (i.e. those who seek to benefit from a depreciation of the HK\$) are penalised by having to pay high interest rates. In other words, those who back Hong Kong and its currency are being rewarded while those who bet against it are penalised.

Also, under the floating rate system any increase in political anxieties produced benefits which accrued only to those who maintained net short positions in HK\$, while the "costs" of the political disturbances affected everyone in Hong Kong through currency depreciation and inflation. In contrast, under the linked rate system the benefits of a stable currency and low inflation accrue to the whole community and the "costs" only affect a narrow cross-section of the population.

Another alleged cost of the linked rate system comes from the deviations between the free market rate for the HK\$ and the official parity. However, this is not so much a cost for the community as a whole but rather a redistribution of the costs and benefits of operating the system among the banks, DTCs, companies, individuals and the government (to the extent that the government intervenes to manipulate interest rates or the exchange rate).

The basic reason for the deviations between the free market rate for the HK\$ and the official parity is that the Hong Kong government decided to adopt a system of partial or limited convertibility rather than a system of full convertibility. (See AMM Nov.-Dec. 1983, "The Stabilisation of the Hong Kong Dollar" pp.20-21, and box on pp. 4-5 of this issue.) Under a system of partial convertibility (i.e. offering convertibility of HK\$ banknotes to US\$ at 7.80 only to banks) the cash arbitrage process is greatly inhibited, and in addition the smooth functioning of the system is forced to depend not on the deposit-to-currency ratio of the public, which historically has been highly stable, but on the rather more variable ratio of

PARTIAL CONVERTIBILITY VERSUS FULL CONVERTIBILITY

The linked rate system for the HK\$ is similar in some respects to the classical gold standard mechanism, or to the silver standard mechanism which operated in Hong Kong until 1935. The essential feature of the gold and silver standard systems, and of the Hong Kong system, is the convertibility of the local currency unit (pounds, U.S. dollars, or Hong Kong dollars) into a fixed quantity of gold, silver or - in the case of Hong Kong - U.S. dollars.

However, whereas under the old gold and silver standards the right of convertibility at the official parity was available to every holder of the local currency, under Hong Kong's present system it is only the banks which enjoy the right of convertibility at the official parity. In order to obtain new banknotes every non-note-issuing bank must pay to the note-issuing banks US\$1.00 for every HK\$7.80, and when redeeming banknotes each non-note-issuing bank will obtain US\$ at the same rate. The two note-issuing banks, Hongkong and Shanghai Banking Corp. and The Chartered Bank, in turn must pay US\$ at the same rate to the Exchange Fund to obtain Certificates of Indebtedness against which they are entitled to issue new banknotes, and these are again redeemable at the same rate. In this way the two note-issuing banks effectively act as agents for the Exchange Fund, enabling all banks to have access to convertibility at the official parity.

However, the man-in-the-street must deal at the best terms he can obtain from the banks, which typically involves some margin to cover banks' holding and handling costs, commission etc. Thus, for the man-in-the-street convertibility is partial and indirect; unlike the banks he cannot go to the government and obtain US\$1.00 for his HK\$7.80 or vice versa. The banks enjoy full convertibility; the public must make do with partial convertibility or convertibility at one remove.

How does this feature affect the operation of the convertible currency mechanism and, in particular, the process of monetary expansion and contraction?

First, it means that deviations of the free market rate for HK\$/US\$ from the official parity will tend to be greater than they would be if individuals had the right of access to the official 7.80 parity for banknotes. This is because, if everyone could obtain HK\$7.80 per US\$1.00, deviations of the free market rate would be limited to the transaction costs incurred by individuals having to (i) convert HK\$ deposits to banknotes, (ii) take the banknotes to a teller's desk operated by the Exchange Fund, (iii) redeposit the US\$ received, together with (iv) any costs due the inconvenience of holding US\$ in place of HK\$. Conversely, if all individuals had the right of convertibility of banknotes at the official 7.80 parity, no foreign exchange dealer at a bank or DTC or money changer's shop could set his prices for HK\$/US\$ outside the narrow limits implied by the transaction costs of steps (i) - (iv) above without losing business to those whose prices were more competitive. Of course the prices for cash, deposits and travellers' cheques would each be slightly different, reflecting their differential handling costs, but all would vary within the limits set by competition among dealers.

Second, in the event of a sudden shift in the balance of payments, e.g. due to a capital outflow, it seems probable that the free market rate for HK\$/US\$ would alter less under a system of full convertibility than under the present system of partial convertibility. Under the present system radical adverse shifts in the balance of

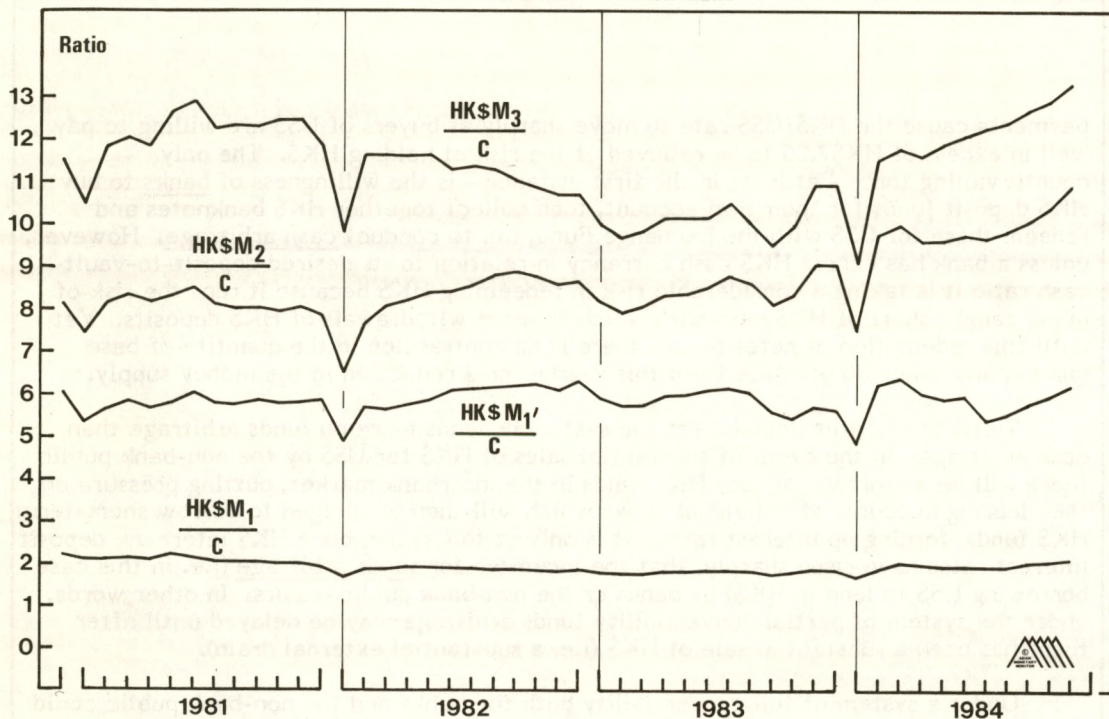
payments cause the HK\$/US\$ rate to move sharply as buyers of US\$ are willing to pay well in excess of HK\$7.80 to be relieved of the risk of holding HK\$. The only countervailing force - at least in the first instance - is the willingness of banks to buy HK\$ deposit funds for their own account, then collect together HK\$ banknotes and redeem these for US\$ with the Exchange Fund, i.e. to conduct cash arbitrage. However, unless a bank has excess HK\$ cash currency in relation to its desired deposit-to-vault-cash ratio it is taking a considerable risk in redeeming HK\$ because it runs the risk of being caught short of HK\$ cash with which to meet withdrawals of HK\$ deposits. Yet until this redemption of notes occurs there is no contraction in the quantity of base money, and hence no pressure from this source for a reduction in the money supply.

Third, due to this impediment the system depends more on funds arbitrage than cash arbitrage. In the event of substantial sales of HK\$ for US\$ by the non-bank public there will be a shortage of spot HK\$ funds in the interbank market, putting pressure on the clearing accounts of individual banks which will then be obliged to borrow short-term HK\$ funds, forcing up interest rates. It is only at this stage, once HK\$ interbank deposit interest rates have risen sharply, that the incentive for funds arbitrage (i.e. in this case borrowing US\$ to lend in HK\$) by banks or the non-bank public occurs. In other words, under the system of partial convertibility funds arbitrage may be delayed until after there has been a substantial sale of HK\$ (i.e. a substantial external drain).

Under a system of full convertibility both the banks and the non-bank public could convert HK\$ banknotes to US\$ (and vice versa) at the official 7.80 parity. As explained above, full convertibility would greatly increase the competitive pressure on dealers to set rates close to the official parity. In addition, given a sudden adverse shift in the balance of payments which caused the HK\$ to weaken (i.e. the HK\$ price of US\$ to rise), the process of cash arbitrage would start much sooner, raising the whole spectrum of deposit interest rates slightly, but provoking funds arbitrage transactions immediately. The public, as final wealth-holders, would find it advantageous to exploit any difference between the free market rate and the official parity, whereas banks, as intermediaries, will tend only to hold such HK\$ banknotes as necessary to meet the needs of depositors and will seldom hold excess HK\$ banknotes collectively unless there has been an unanticipated downward shift in the demand for HK\$ deposits. (Even in this case banks may prefer to wait until they perceive the reduced demand for HK\$ deposits to be permanent before redeeming their excess holdings of HK\$ cash in order to adjust their deposit-to-vault-cash ratios down to their desired or optimal level.)

To summarise, under the system of partial convertibility the incentive for cash arbitrage by banks is relatively weak since there are many complex factors entering banks' profit maximisation function, whereas under a system of full convertibility the incentive for individuals to conduct cash arbitrage is relatively straightforward. Moreover, funds arbitrage under partial convertibility will only be stimulated once a substantial shortage of funds has developed in the interbank market, whereas under a system of full convertibility there need be no such delayed reaction. We may hypothesize that it is the shortcomings of the system of partial convertibility which account for the occasional sharp deviations of the free market rate away from the official parity. Theory suggests that such deviations would be considerably reduced under a system of full convertibility.

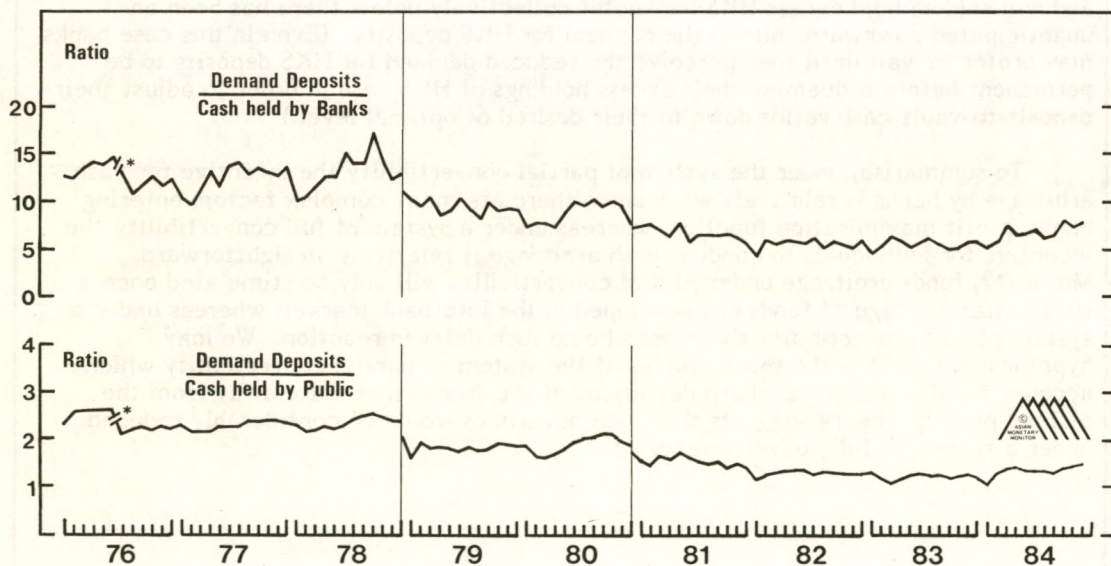
HONG KONG : CHART 1
THE MONETARY MULTIPLIERS



C denotes Total Cash Currency

M1' equals sum of Demand Deposits, Savings Deposits and Cash held by Public.

HONG KONG : CHART 2
THE MONETARY DETERMINANT RATIOS (FOR HK\$ M₁)



*Deposits at 7 days notice or less previously included under Demand Deposits are now included under Time Deposits.

deposits-to-vault-cash held by the banks (see Chart 2). If convertibility at 7.80 was made available to everyone who held HK\$ banknotes and not just the banks, then the divergence between the free market rate for HK\$ and the official parity would, allowing for transactions costs of different types of money, be minimal. Moreover, the volatility of short-term interest rates under a system of full convertibility would tend to be less than under present arrangements because adjustments to the money supply would be quicker, and therefore deviations away from an equilibrium level of the money supply would occur less frequently.

Summarising the argument so far, the benefits of the present system to the community as a whole far outweigh the costs of the technical defects of the system, which in turn suggests a *prima facie* case in favour of retaining the present system rather than introducing any changes.

Turning to the three principal proposals which have from time to time been made to change the linked rate system, aside from the general arguments cited above in favour of the new mechanism, there are objections in principle to each specific proposal, and hence good grounds for not adopting the proposed reform.

First, there are those who believe the linked rate mechanism should be abandoned and the Hong Kong currency should be allowed to float. Those who make this proposal do not appear to understand that the linked rate system was introduced not simply to deal with the crisis situation of September 1983, but also to deal with some of the deeper problems which had troubled Hong Kong's monetary system since the early 1970s. The immediate problem at the time of the currency panic in September 1983 was that the Hong Kong government could not counteract currency flight by tightening the money supply, raising interest rates, and attracting funds back to Hong Kong. This was symptomatic of the underlying problem of the lack of monetary control which had plagued the system during the decade of floating exchange rates (1974-1983). For example, in the period 1978-1981 Hong Kong suffered extremely rapid rates of bank credit expansion (over 60%) and money supply growth (over 40%). As a result property prices and rents spiralled, the currency weakened, and generalised inflation took a firm hold. Conversely in 1982 and 1983 money supply and bank credit growth slumped. The downturn in business activity, even before the Sino-British negotiations in Peking started, was very severe, and as a result there were numerous problems in the property sector, among the deposit-taking companies, among commodity traders and in other sectors of the economy.

These extremes of boom and bust were largely a consequence of a monetary system in which the process of bank credit and money creation were independent of the process of external adjustment. Since the foreign exchange rate could adjust to the internal price level or the price level could adjust to the external foreign exchange rate, changes in the exchange rate or the domestic price level could be initiated independently. The exchange rate was vulnerable to sudden shifts in capital flows, whilst the growth of the money supply was mainly determined by the willingness of the banks to create new credit. The money supply, in short, was not subject to any external discipline.

The new currency arrangements of October 1983 make it very clear that in future Hong Kong's monetary growth will be closely linked to the performance of the balance of payments on current and capital account. Thus the linked rate system for the HK\$ not only solved the problem of the panic in September 1983, but it also solved the underlying problem of monetary control in Hong Kong. This is a most important reason why the linked rate system should not be abandoned now.

THE INTEREST RATE AGREEMENT - WHO BENEFITS ?

The Interest Rate Agreement (IRA) limits the interest rates payable on time and savings deposits under HK\$500,000 (approx. US\$64,000) at licensed banks in Hong Kong to rates set by the Hong Kong Association of Banks (HKAB). These rates are substantially below those offered to large depositors at free market rates. This means that some of the benefits of the linked rate system are denied to the small, retail depositor, though competition among the banks and the growth of personal incomes in Hong Kong can be expected gradually to erode the market share of deposits covered by the Interest Rate Agreement.

Arguments in favour of maintaining the Interest Rate Agreement are normally cast in terms of a barely-disguised protectionism. The official view is that free competition for deposits would undermine the stability of the banking system by threatening the profitability of the smaller, local banks, and thereby ultimately harm depositors. In reality banks seldom fail because they bid competitively for depositors' funds; normally they fail on account of mistakes in lending policy, such as maturity mismatching or excessive concentration in one sector, or they fail due to mismanagement or fraud.

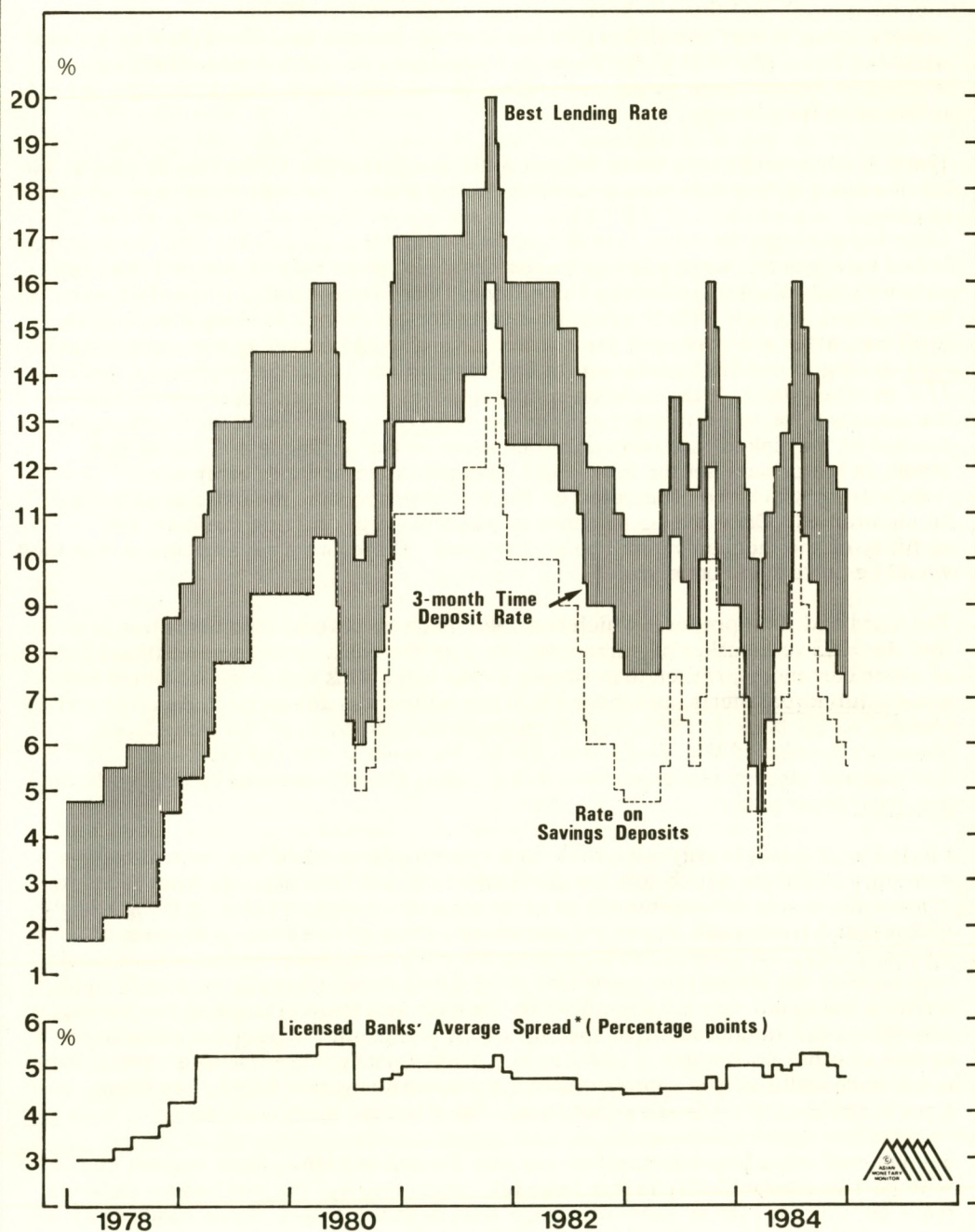
The official view makes too little of the benefits that would accrue to the economy as a whole from abolition of the Agreement. A distinction needs to be made between the desirability of some form of protection for depositors and the alleged need for "stability of the banking sector". There is a legitimate case for depositor protection through tighter prudential ratios, through stricter supervision, or through some form of compulsory insurance, but depositor protection should not extend to an officially-sanctioned structural rigidity or protection of the status quo in the banking sector. Just as consumers have benefited from the recent (1984) price war and the resulting structural shake-out among the supermarkets in Hong Kong, depositors would benefit from more competitive deposit interest rates and some restructuring among the banks.

Abolition of the HKAB Interest Rate Agreement would oblige licensed banks' deposit interest rates to move towards their competitive, free market equilibrium levels. This would lead to greater financial intermediation between savers/depositors and investors/borrowers, increasing the incentives to save through higher returns to savers, and at the same time raising the average efficiency of investment. This is because higher real rates would deter borrowers with low-yielding investment projects. Since savings are suboptimal when interest rates are artificially restricted, these benefits would be enhanced if interest rates were allowed to rise to free market equilibrium levels.

The main beneficiaries of the IRA are bank shareholders who benefit from the artificially wide spread between retail deposit interest rates and bank lending rates. Accurate data on the overall cost of funds to banks in Hong Kong and average lending rates are not available, but an indication of the spread due to the IRA is the difference between the HSBC's Best Lending Rate and an average of the Savings Deposit Rate and the rate on 3-month Time Deposits, both of which are set by the Interest Rate Agreement (see chart above). Over the period 1978-84 this spread has averaged 4.69 percentage points on a time-weighted basis.

Supposing HK\$ deposits subject to the IRA amount to HK\$90 billion - i.e. all of the savings deposits and half of the time deposits at banks in HK\$ - reduction of the banks' spread by one percentage point would benefit depositors by HK\$900 million, and in addition the increased pressure on banks' margins would compel an improvement in the allocation of bank resources to the advantage of all bank customers.

Bank Spreads Under The Interest Rate Agreement



*Calculated as Base Lending Rate minus $\left(\frac{\text{Savings Rate} + \text{3-month Time Deposit Rate}}{2} \right)$

A second proposal, which is sometimes made, is not that the mechanism should be changed, but that the rate against the US\$ should be changed. At the time of the original announcement of the linked rate system on October 15th, 1983, the Financial Secretary said that he would not contemplate moving the rate downwards (i.e. devaluing), and this has been repeated subsequently. However, a common anxiety today is that the US\$ might fall sharply, perhaps by 20% or 30% on a trade-weighted basis, and that under these circumstances the HK\$ would effectively depreciate against most major currencies. A related fear is that this might set off inflation in Hong Kong.

There is little doubt that these anxieties are exaggerated. Moreover, so long as the US monetary authorities pursue sensible money growth policies there is no serious likelihood of a collapse of the US\$ or of a serious outbreak of inflation in the US. Since Hong Kong's inflation rate is tied to the inflation rate in the USA through the linked rate system, even a fall in the external exchange rate of the US\$ does not automatically spell inflation for Hong Kong. More importantly, if the HK\$ were to be revalued, the sole effect would be a once-for-all change in Hong Kong's price level but, after a transitional period, Hong Kong would revert to the same inflation rate so long as the HK\$ continued to be linked to the US\$. (See Appendix, pp. 16-17.) In other words, a revaluation simply imposes significant adjustment costs on the economy for no permanent gain in the underlying inflation rate. Further, the success of the linked rate mechanism depends on the willingness of banks and others in the private sector to conduct cash arbitrage or funds arbitrage transactions which are predicated on their confidence that the official parity will be maintained. Once that confidence is jeopardised by shifting the rate, the viability of the mechanism will be undermined. Therefore a revaluation of this kind would be unwise and unhelpful.

The third and final proposal which has been made by several commentators is to link the HK\$ to a basket of currencies, such as the SDR, or to some abstract index of other currencies, rather than simply to the US\$. This is a proposal which has some intellectual merit, and indeed it is one which was advanced in Asian Monetary Monitor as far back as 1979. (See "Proposals for a Reform of the Hong Kong Monetary System" AMM, Mar.- Apr. 1979). However in the political and institutional circumstances of Hong Kong today, the proposal has some significant practical drawbacks.

First, the proposal is only applicable in a system where there is a central bank or monetary authority which sets the exchange rate and then actively intervenes to control the supply of base money so as to enforce its chosen rate. In Hong Kong's institutional framework where the monetary authority is a passive supplier of currency only, not bank reserves, linking the HK\$ to a basket of currencies would require that the linked rate expressed in US\$ be altered virtually on a daily basis, and this would not only be disruptive to the cash arbitrage process of the banks, but also conducive to unproductive speculation by the public. Fixing the currency to a basket of other currencies is feasible in a discretionary system with a central bank, but it is doubtful if it is appropriate in an automatic system which, like Hong Kong's, relies on private sector arbitrage for effective stabilization.

Second, and more important, given the way the linked rate system was set up (i.e. with partial convertibility rather than full convertibility) the mechanism depends more on interest rate or funds arbitrage than cash arbitrage. While funds arbitrage is straightforward when the currency is linked to one currency, it is a different matter when the currency is linked to a basket. Funds arbitrage under a fixed rate

system is simple because it is easy to see when interest rate differentials between two countries arise, and, so long as people are convinced that the fixed parity will be maintained, there is ample incentive to move funds from one area to another and thereby restore equality of interest rates in the two currency areas. However, under a basket arrangement where the local currency is not tied to any one single currency it is not clear what the equilibrium market interest rate in the domestic currency area should be, and therefore there will be greater hesitation on the part of arbitrageurs to borrow funds in one centre and lend to another. (Basically arbitrageurs in this position are taking on both an exchange rate risk and an interest rate differential risk.) Thus moving to a basket arrangement would actually inhibit the funds arbitrage process, whereas to maximise the efficiency of Hong Kong's linked rate system the arbitrage process needs to be enhanced, not limited.

In conclusion, it should be clear that Hong Kong's linked rate system is not perfect, and as suggested it could be improved by moving from a system of partial convertibility to a system of full convertibility. However, it would not be improved by any of the three specific proposals examined above.

To summarise:

- 1) The proposal to return to a floating exchange rate implies abandoning monetary control, and it would also expose the HK\$ to a possible repetition of the crisis of September 1983.
- 2) The proposal to revalue the exchange rate against the US\$ implies the imposition of adjustment costs in exchange for no permanent benefit, and by undermining confidence in the fixed parity it would undermine the future operation of the arbitrage process on which the automatic adjustment mechanism depends.
- 3) The proposal to fix the HK\$ to a basket of currencies would satisfy the requirement for monetary control, but it would undermine the operation of the system by making the arbitrage process even weaker than it is under the current system of partial convertibility.

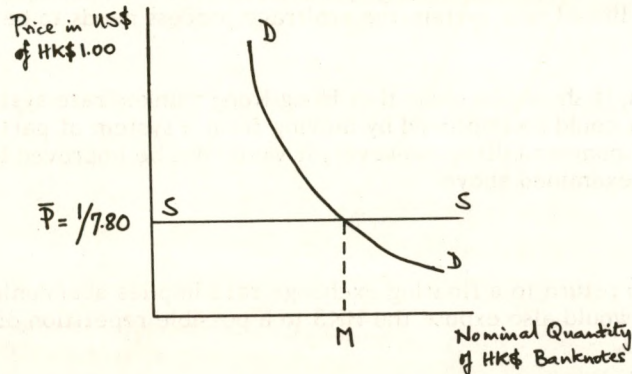
In the absence of other serious proposals, therefore, it follows that the linked rate system for the HK\$ would be best retained both in its present form (i.e. linked solely to the US\$) and at the present rate of HK\$7.80.

HONG KONG / APPENDIX

(A) SIMPLE ANALYTICS OF HK\$/US\$ LINKED RATE SYSTEM

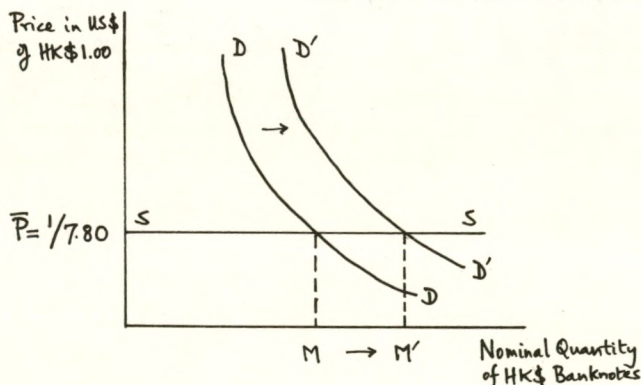
Under the linked rate system the price of money is controlled, not the quantity.

Fig. A.1.



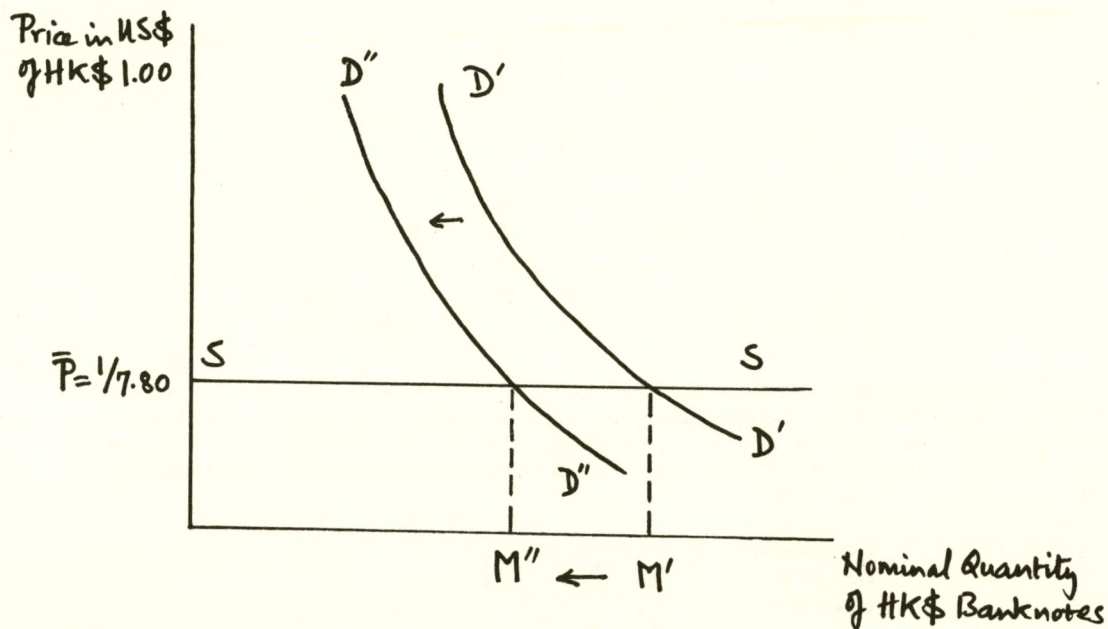
Under the linked rate system for the HK\$ the price of HK\$ banknotes is set at US\$1.00 = HK\$7.80 or HK\$1.00 = US\$1/7.80 (= 12.8205 cents) on the vertical axis, shown by the horizontal supply curve, SS. The perfectly elastic supply curve reflects the willingness of the Hong Kong authorities to issue or redeem any number of Certificates of Indebtedness (equivalent to HK\$ banknotes) at the fixed price in US\$. The quantity of HK\$ banknotes demanded depends on the slope and position of the demand for HK\$ banknotes, DD. The intersection of SS and DD gives the nominal quantity of HK\$ banknotes demanded, M. Since banknotes are convertible into HK\$ deposits and vice-versa the price of deposit money in US\$ cannot deviate far from the official parity for banknotes.

Fig. A.2.



Under the linked rate system for the HK\$, changes in the quantity of money result from shifts in the demand for money. Since the Hong Kong authorities supply HK\$ banknotes passively at the fixed price of HK\$1 = US\$1/7.80, if demand shifts to the right (DD to D'D') the quantity of banknotes demanded will increase from M to M'. Such increases in the money supply could continue so long as they were consistent with equilibrium in Hong Kong's overall international balance of payments (i.e. on combined current and capital account).

Fig. A.3.

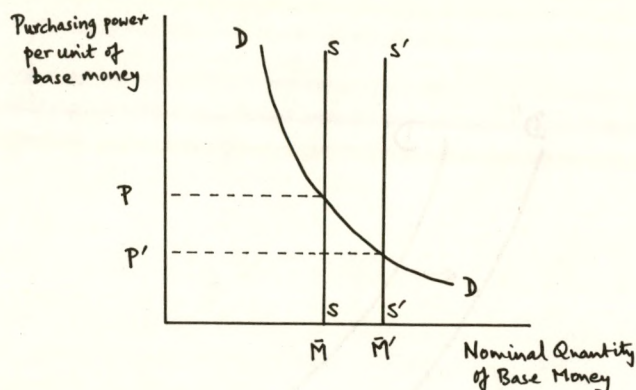


Alternatively, if the demand for the HK\$ banknotes declines (shifts to the left) from $D'D'$ to $D''D''$, the quantity of HK\$ banknotes falls from M' to M'' . (The mechanism for this kind of contraction is explained in AMM Vol. 8 No. 1, pp.4-5.) As long as the exchange rate is fixed, the money supply and the internal price level will adjust automatically until there is equilibrium in the balance of payments at the fixed exchange rate.

(B) SIMPLE ANALYTICS OF MONETARY BASE CONTROL

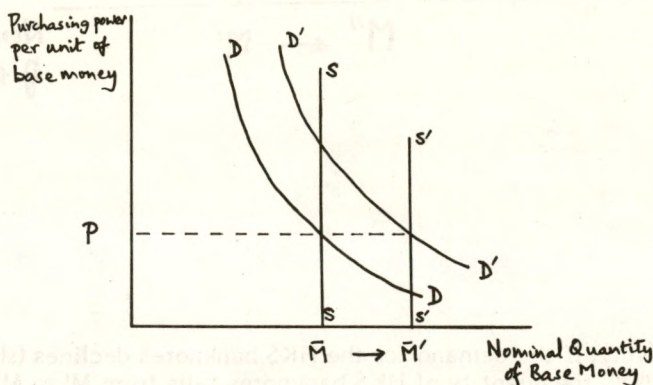
Under monetary base control the quantity of base money is controlled, not the price.

Fig. B.1.



Increasing the quantity of base money from $\bar{M}$ to $\bar{M}'$ with the demand for money DD unchanged reduces the purchasing power (or value or foreign exchange price) of each nominal unit of money from P to P' . Conversely, reducing the quantity of base money from $\bar{M}'$ to $\bar{M}$ with demand DD unchanged raises the purchasing power of each nominal unit of base money from P' to P .

Fig. B.2.



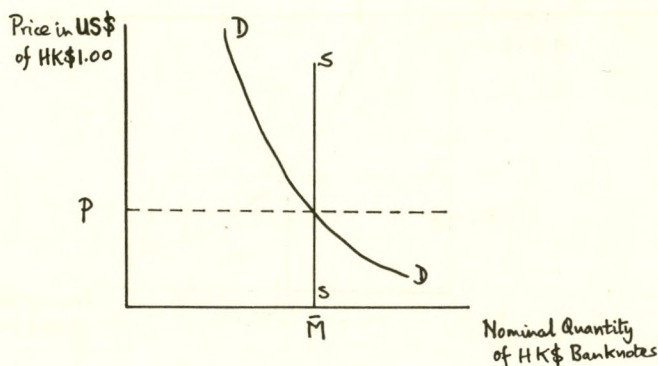
As productivity increases and real incomes rise, the demand for money also increases. Hence in a conventional monetary system with a central bank which can control the money supply (or base money) at its own discretion, the monetary authorities deliberately adjust the quantity of money in response to shifts in money demand, usually aiming to keep the purchasing power of money (measured in terms of the domestic price level or as the external exchange rate) roughly stable. For example, with demand DD , the quantity supplied is $\bar{M}$. Now suppose the demand for money increases (shifts to the right) to $D'D'$ over the next twelve months. The central bank will try to anticipate the increase in demand for money over the year by steadily increasing the quantity of money to $\bar{M}'$, at which level the purchasing power of money (i.e. price level or exchange rate) P , shown on the vertical axis is unchanged.

As with the linked rate system the monetary authority only supplies part of the total money supply - namely, base money. Since deposit money is convertible into base money and vice-versa, the value or purchasing power of each unit of the monetary base under both systems will be equal to each unit of deposit money.

(C) EFFECT OF FLOATING THE HONG KONG DOLLAR

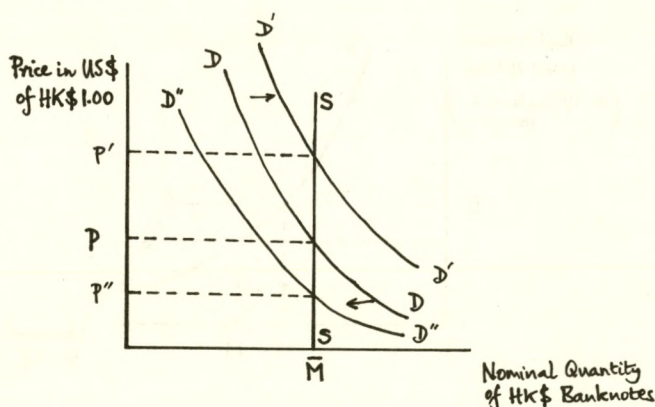
Since Hong Kong has no central bank to control the quantity of base money, abandoning the linked rate system and refloating the Hong Kong dollar would imply moving to a system in which neither the price nor the quantity of Hong Kong dollars was controlled.

Fig. C.1.



If the official 7.80 parity for HK\$ banknotes were to be abolished and the currency were to be floated the quantity of money supplied need no longer be consistent with equilibrium in the international balance of payments at 7.80 (as in A.2 and A.3). Assuming the Hong Kong authorities continued to allow HK\$ banknotes to be issued passively, the demand for banknotes would be dependent upon the amount the public and the banks chose to hold in relation to the volume of deposits. Deposits in turn are related to the amount of bank credit, and therefore the proximate determinant of the money supply would be the interest rate set by the banks' interest rate cartel. But there is no intrinsic reason why the banks should set interest rates at a level consistent with balance of payments equilibrium.

Fig. C.2.



Now assume the money supply is fixed in the short term ($\bar{M}$). Supposing there was a sudden shift in the demand for HK\$ due to a change in perceptions about the political future of Hong Kong, or due to other factors, how would the exchange rate behave?

With a rightward shift in the demand for HK\$ from DD to $D'D'$, there would be an upward movement in the purchasing power of the HK\$, and also in the exchange rate from P to P' . Conversely, in the event of a leftward shift in the demand for HK\$ to $D''D''$ the purchasing power and/or exchange rate would depreciate to P'' . This is essentially what happened in the HK\$ currency crisis of September 1983. Thus refloating the Hong Kong currency without first establishing a central bank to control the quantity of base money would mean that, even with no change in the quantity of money, the HK\$ would become vulnerable to the kind of sharp depreciation which occurred in September 1983.

(D) EFFECTS OF A REVALUATION OF THE HK\$ UNDER THE LINKED RATE MECHANISM

Fig. D.1.

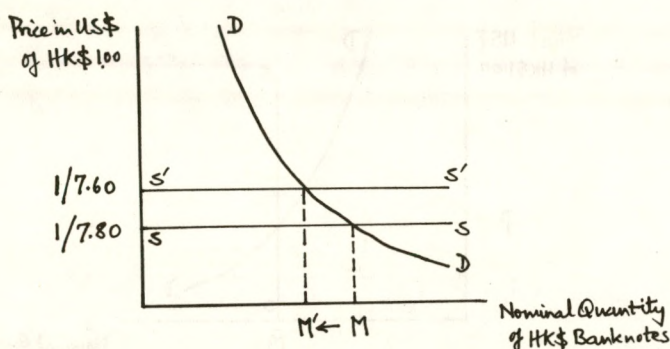


Figure D.1 shows the adjustment of the quantity of HK\$ to an upward revaluation of the supply price of HK\$ from HK\$7.80 to HK\$7.60 per US\$ (or a change in the US\$ price of HK\$1.00 from US\$1/7.80 to US\$1/7.60). The supply of money, SS, shifts to S'S', but the supply curve is still horizontal (i.e. perfectly elastic) at the new exchange rate (7.60). The money supply, M, adjusts downwards to M' (moving to the left on the horizontal axis), reflecting a movement along the demand curve for money (DD).

Fig. D.2.

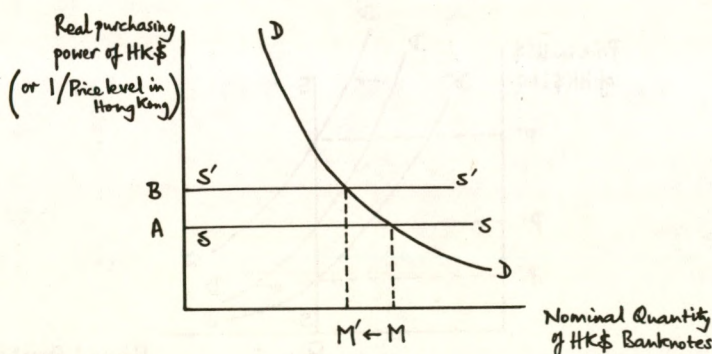
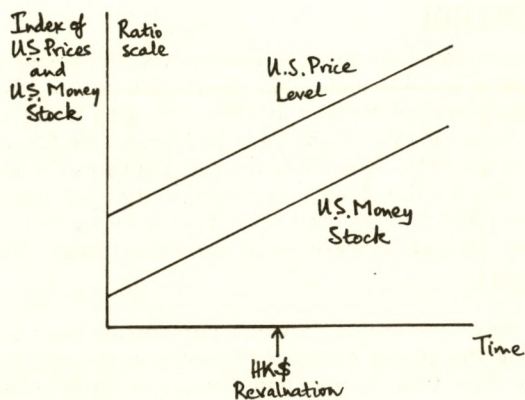


Figure D.2 shows the effect of the revaluation on the real value of each nominal unit of HK\$ money (or its equivalent, the inverse of the overall price level). Since the money supply shifts from M to M', the value of a nominal unit of money increases from A to B, i.e. the price level declines. This is a once-for-all change in response to the revaluation, but it tells us nothing about how the price level in Hong Kong behaves over a long period in relation to prices in the U.S.A. For that we must turn to Figures D.3 and D.4.

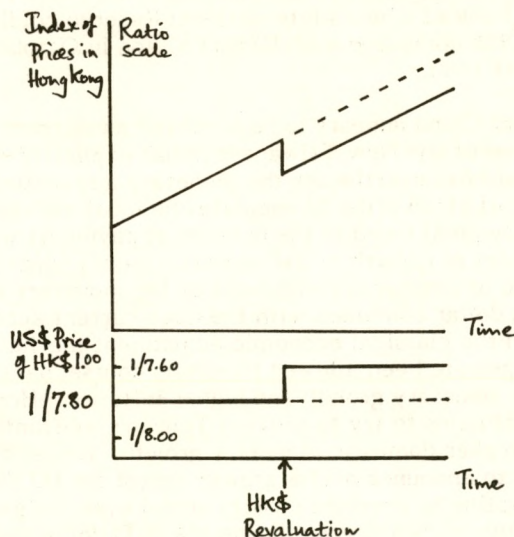
All figures so far have been confined to static analysis. In Figures D.3 and D.4 we introduce time on the horizontal axis, and the analysis shifts to dynamics.

Fig. D.3.



The US money stock is assumed to be rising at a constant rate, and prices in the U.S. are also assumed to be rising at a constant rate, i.e. the U.S. economy is in a steady state equilibrium. At a certain point in time the HK\$ is revalued, but there is no change in the rate of U.S. monetary growth and accordingly no change in the rate of inflation in the U.S.

Fig. D.4.



In Hong Kong prices are rising at a constant rate roughly equal to the rate of increase of prices in the U.S.A. prior to the revaluation of the HK\$. Upon revaluation the price level in Hong Kong (which is the inverse of the purchasing power of the HK\$) makes a once-for-all downward shift, consistent with that in Figures D.1 and D.2.

However, since Hong Kong's international payments must balance at a price level which is consistent with U.S. prices at the new exchange rate of 7.60, Hong Kong's money supply must adjust in future to keep Hong Kong prices in line with U.S. prices as before. Therefore, following the once-for-all correction (which may in practice be spread over some transitional period of time), Hong Kong prices start to rise again in line with U.S. prices at the same rate as previously.

TAIWAN

RECORD CURRENT ACCOUNT SURPLUSES LEAD TO PROBLEMS OVER MONETARY CONTROL

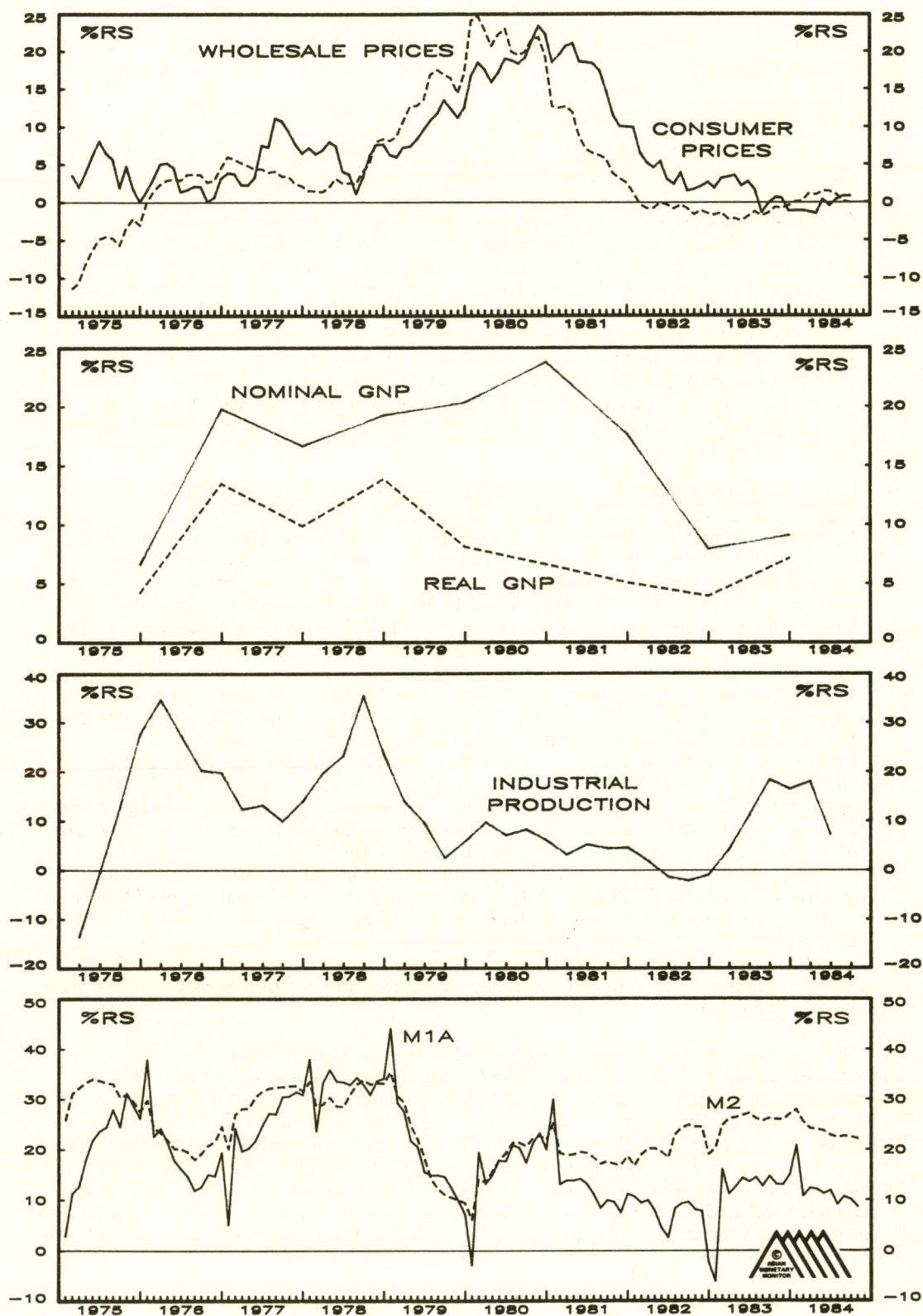
During the last two years the Taiwanese economy has recovered strongly after a period of depressed real growth in 1981 and 1982. Real GNP rose 7.1% in 1983 compared with 3.8% in 1982 and has accelerated further in 1984, rising by nearly 12% in the year to June. Industrial production rose by 18% in the year to March (see Chart 1), aided by a 34% year-to-year increase in exports. The Chairman of Taiwan's Council for Economic Planning and Development, Mr. Yu Kuo-hwa, has forecast that per capita nominal incomes may rise by 9.9% to US\$2,940 during 1984. This is likely to represent a substantial increment to real per capita incomes as consumer price inflation measured just 0.8% in the year to August.

A further substantial improvement in Taiwan's current account surplus has been the principal influence underlying the strong cyclical recovery in the local economy. It is interesting and important to note that Taiwan had already enjoyed substantial current account surpluses prior to the US economic recovery of 1983. During the final quarter of 1982 Taiwan's current account surplus approached US\$2 billion at an annual rate. This was mainly the result of depressed growth in the local economy during 1981/82 and a corresponding reduction in the demand for imports. As the recovery in the US and other developed economies got under way in 1983 the demand for Taiwanese exports rose substantially, leading to significant increments to Taiwan's external surplus (see Chart 2). (Taiwan's exports to the US rose 71% in the year to June 1984 and Taiwan's bilateral trade surplus with the US measured US\$6.7 billion during 1983.) By mid 1984, Taiwan's overall trade surplus was running at between two and three times the level of late 1982. Meanwhile, the Central Bank of China's International Reserve holdings had risen to US\$15.4 billion in July 1984 compared with US\$8.3 billion in October 1983 and US\$1.6 billion at the beginning of 1980.

The Central Bank of China appears to have moved away from its previous policy of pegging the external value of the New Taiwanese dollar explicitly at a predetermined rate against the US dollar but nevertheless the monetary authorities intervene heavily on the foreign exchanges markets in order to regulate the local exchange rate. Therefore, over the long term, the cyclical trend in the balance of payments will generally prove to be the primary determinant of growth in the domestic money supply, through the impact of changes in the balance of payments component of the monetary base. Thus, official management of the N.T. dollar combined with the huge current account surpluses of the last two years could, had the classical economic adjustment mechanism under a fixed or heavily managed exchange rate been allowed to run its course, have led to a substantial cyclical rise in domestic monetary growth and higher inflation. However, the Central Bank of China has been at pains to try to prevent Taiwan's substantial external surpluses from being reflected in higher domestic monetary growth. Indeed the Central Bank of China has gone so far as to announce a 15% growth target for M2 during 1984. This gives the appearance of attempting to exercise direct control over the growth of the money supply. In fact, their policy of heavily regulating the N.T. dollar exchange rate implies that control over domestic monetary growth occurs mainly indirectly through changes in the overall balance of payments.

The Central Bank of China's attempts to limit domestic monetary growth in the face of large external surpluses can broadly be divided into two categories. First, the Central Bank of China has implemented a range of measures designed to reduce both Taiwan's external surplus and the increase in the central bank's International Reserves. Second, the monetary authorities have attempted to offset the expansionary monetary impact of a rapidly expanding external surplus under a pegged or heavily managed exchange rate regime.

TAIWAN: CHART 1
MONEY, OUTPUT AND PRICES



Measures Designed to Reduce Taiwan's Balance of Payments Surplus and the Level of International Reserves

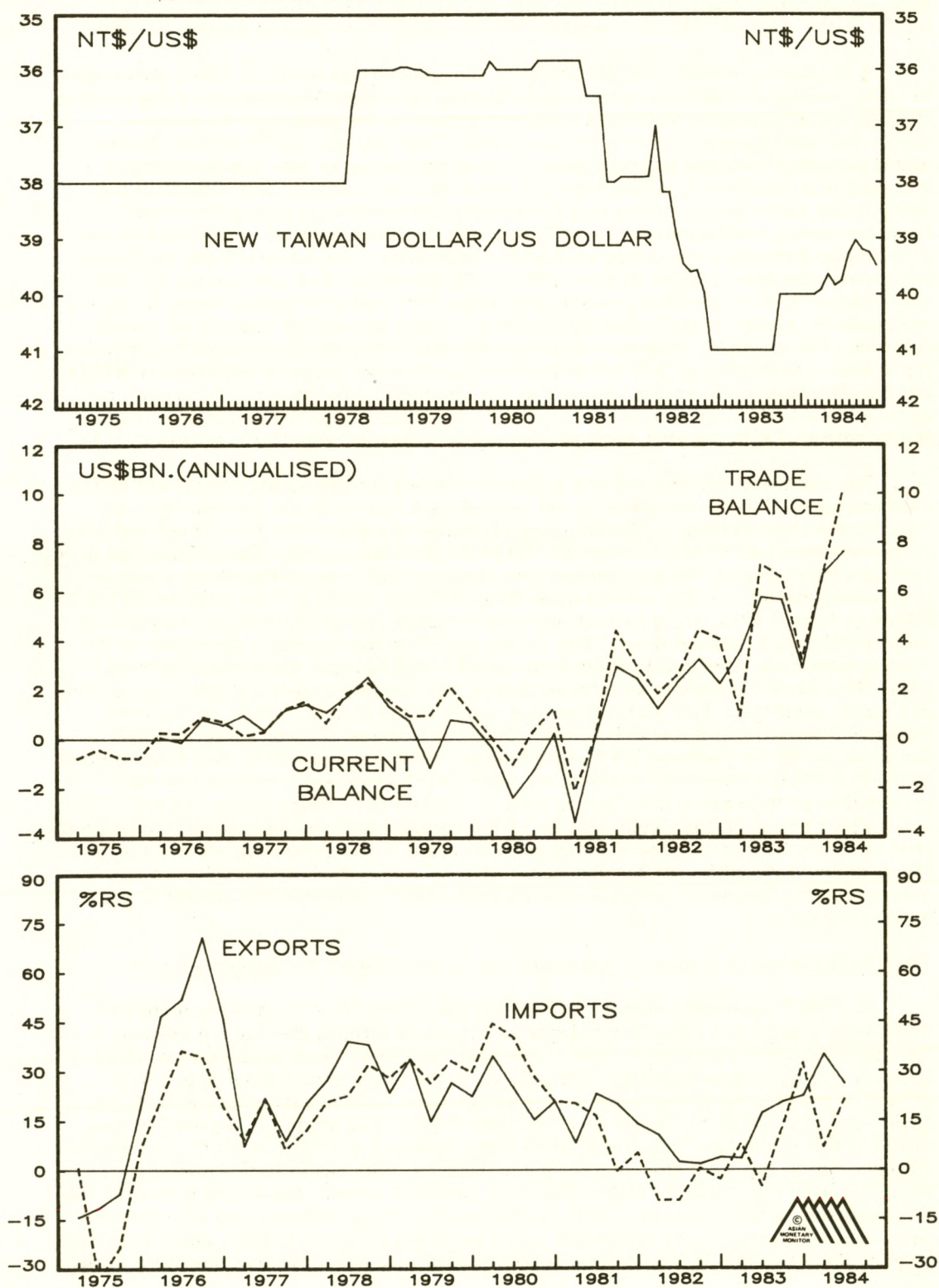
- i) Reduced Import Tariffs and Controls. In October and November 1983 the Taiwanese government reduced tariffs and abolished or suspended import controls on more than 2,000 products, including gems, petrochemicals and farm, fishery and live-stock products in an attempt to stimulate import demand.
- ii) Increased Net Official and Private Capital Outflows. In May 1984 Taiwan's Ministry of Finance instructed local Taiwanese companies to increase their N.T. dollar financings and to reduce their US dollar borrowings. The Ministry of Finance pointed out that domestic loans were at an attractive interest rate differential compared with incremental US dollar denominated debt. At the time, local prime rate was 10% as opposed to 11 1/2% in the US. In addition, on August 7th 1984, the Ministry of Finance instructed state and private enterprises to attempt to trim their net borrowings from foreign banks. The combined impact of these measures is, so far, difficult to quantify but Central Bank of China statistics show that Taiwan's total foreign debt has declined from US\$9.2 billion in July 1983 to US\$8.0 billion in July 1984.
- iii) Increased Permissible Commercial Banks' Foreign Exchange Holdings. In September 1984, the Central Bank of China raised the limit on the amount of foreign exchange that commercial banks may hold by 50%. The motive for this measure is to discourage commercial banks' sales of foreign exchange to the central bank, thereby providing a mild constraint in the growth of the balance of payments source of the monetary base. In July 1984, Taiwan's local commercial banks held gross foreign assets amounting to NT\$249 billion (approximately US\$6.2 billion) and net foreign assets of NT\$94 billion.
- iv) A Modest Appreciation of the N.T. Dollar. The fundamental source of the large increase in Taiwan's current account and balance of payments surplus must be that the N.T. dollar has been maintained at an undervalued level on the foreign exchanges. In our last article on the Taiwan economy (AMM Vol. 7 No. 2) we cautioned that the 1982 devaluation of the N.T. dollar - from NT\$36 to NT\$40 against the US dollar - risked encouraging a substantial increase in Taiwan's current account surplus and subsequent upward pressure on the local currency in the event of economic recovery abroad. In practice, whilst the Central Bank of China has gradually appreciated the N.T. dollar from an average of NT\$40.27 in the fourth quarter of 1983 to NT\$39.18 in July 1984, the rise in the external value of the local currency has been inadequate to stem the increased in Taiwan's current account surplus.

Measures Designed to Offset the Expansionary Monetary Impact of a Substantial Balance of Payments Surplus

Not surprisingly, the policies inaugurated to reduce Taiwan's overall balance of payments surplus have met with only modest, if any, practical success. Chart 3 illustrates the strong growth in the foreign exchange source of Taiwan's monetary base. The Central Bank of China net foreign assets have increased from NT\$115 billion in December 1980 to NT\$261 billion in June 1984. Had the Taiwanese authorities not offset partially the increase in the balance of payments component of the base then other things being equal, the monetary base would have risen at an annual pace of 43% in the period June 1982 to June 1984. This would almost certainly have spawned an explosion in domestic money growth. In fact, however, the monetary base has risen at an annual rate of 14.2% since mid 1982.

As in prior episodes where the Central Bank of China has offset a sharp rise in the net foreign assets source of the base, in this cycle the Taiwanese authorities have relied

TAIWAN: CHART 2
THE EXTERNAL COMPONENT AND THE EXCHANGE RATE



heavily upon reducing net central bank credit to commercial banks in order to constrain growth in the monetary base. It is evident from Chart 3 that net central bank credit to commercial banks' contribution to the base has declined substantially from NT\$173 billion at the start of 1980 to a negative NT\$43 billion in the second quarter of 1984.

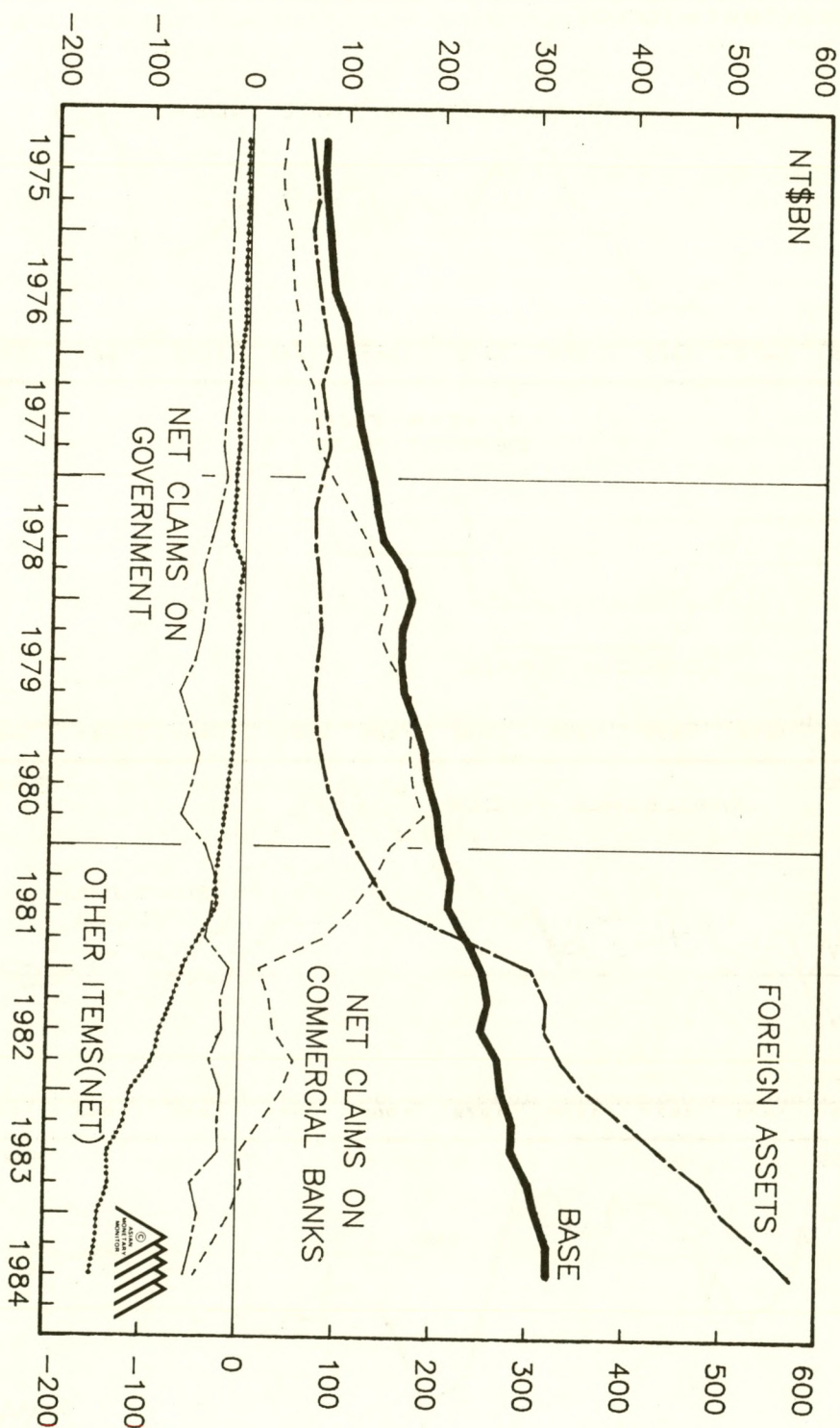
A decline in central bank net credit to the commercial sector is often, particularly in many developed economies which have floating exchange rates and where the trend in the balance of payments need have no direct impact on the growth of the base, associated with rising short term interest rates. Thus just as a fall in the net foreign assets source of the base typically suggests that the exchange rate has been pegged or managed at a level which is "too high", so too a decline in central bank credit to the commercial banks often implies that the central bank's discount rate is "too high". However during this business cycle in Taiwan the decline in central bank credit to the commercial banks has been associated with a reduction in the Central Bank of China's rediscount rate from 10.25% in April 1982 to 7% currently. The explanation for this combination of developments probably lies in the fact that commercial banks in Taiwan are presently highly "liquid": that is to say they hold a substantial quantity of excess reserves. For example, in June of this year domestic commercial banks held reservable liquid assets amounting to NT\$247 billion compared with a required minimum of NT\$78 billion. The build up in excess reserves at the commercial banks reflects, in part, a decline in domestic loan demand. Commercial bank lending to the domestic private sector rose 11.1% in the year to September 1984 compared with 19.2% growth in 1983.

The additional offset to strong growth in the net foreign assets component of the base has been a further reduction in net central bank claims on the government. In Taiwan, the Central Bank of China's gross claims on the government are small and have varied between just NT\$11.4 billion and NT\$5.9 billion since 1978. The contraction in net central bank claims on the government over the past two years reflect both a rise in government deposits at the central bank, from NT\$28.8 billion in June 1982 to NT\$61.35 billion in August 1984, and a further increase in "other items" on the liabilities side of the central bank's balance sheet. The "other items" or non-monetary liabilities of the central bank have risen nearly three-fold, to NT\$151.65 billion, since the middle of 1981. This likely represents an increase in the "net worth" category of the Central Bank of China's liabilities. This would arise as a result of the income stream accruing to Taiwan's International Reserve holdings. Over the last year Taiwan's International Reserves, which we presume are invested mainly in US Treasury Bills, may have yielded as much as US\$1 billion in investment income. This investment income would be recorded as an increase in the Central Bank of China's net foreign assets and the counterpart entry, on the liabilities side of the central bank's balance sheet, would (in the first instance, at least) be represented as an increase in the central bank's net worth. (Thus, an increase in the net foreign assets of the Central Bank as a result of a rise in investment income need have no direct implication for changes in the growth of the monetary base.)

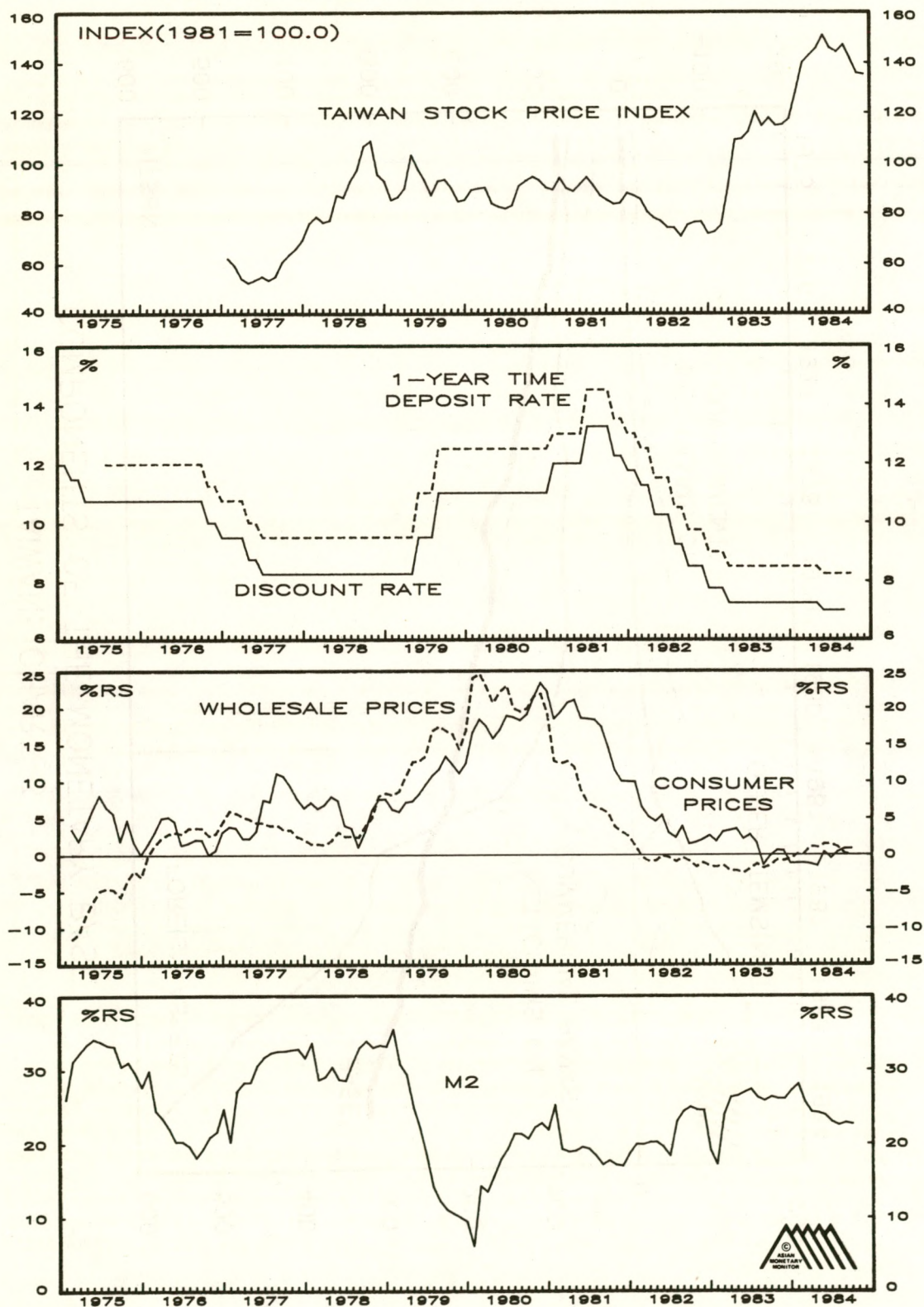
The Likely Course of Economic Adjustment in Taiwan During this Business Cycle

Had the Taiwanese monetary authorities not offset the expansionary monetary impetus of a large and expanding balance of payments surplus, the current upswing in the Taiwanese business cycle would likely have been typical of those in economies which follow a closely pegged exchange rate policy. In the absence of measures to offset growth in the balance of payments source of the base, Taiwan's monetary growth would have soared far above the levels recorded over the last two years. It is probable that, initially, this would have been associated with a booming domestic economy and an even stronger rise in the local stockmarket index (Chart 4) than has in fact occurred. However, over time, sharply higher domestic monetary growth and strong growth in the local economy would typically have been followed by rising inflation and an increased demand for imports. These influences would generally combine to bring about eventually a cyclical contraction in Taiwan's monetary growth rate and a cyclical downturn in the

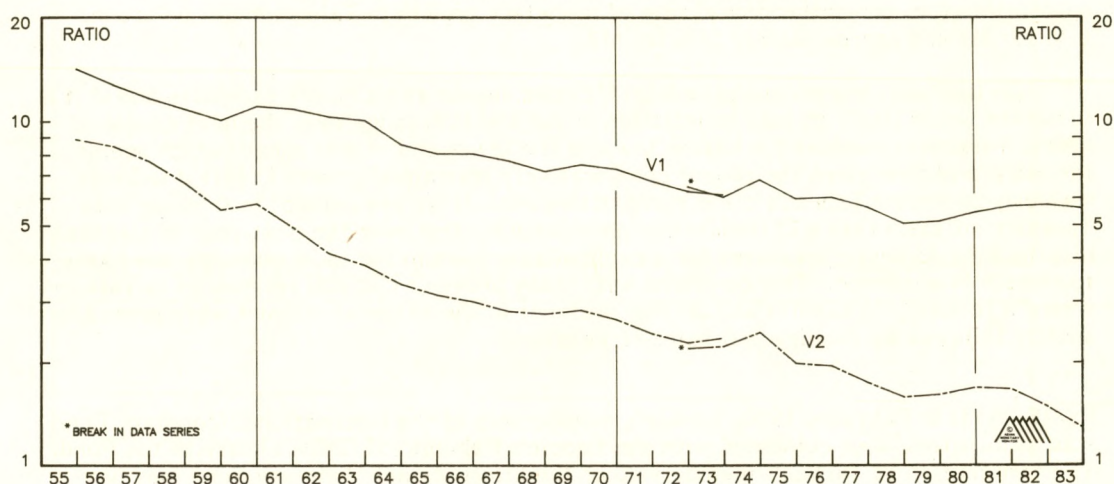
TAIWAN: CHART 3
COMPONENTS OF THE MONETARY BASE



TAIWAN: CHART 4
LIQUIDITY INDICATORS AND STOCK PRICES



TAIWAN
CHART 5: INCOME VELOCITY OF CIRCULATION



domestic economy.

By offsetting the expansionary impact of rapid growth in the net foreign assets source of the monetary base, the Taiwanese monetary authorities have maintained monetary growth at a level which is lower than would otherwise have been the case. As a result, the strength of the recovery in the domestic economy has also been tempered and inflation has remained modest.

Nevertheless, since the end of 1981 the average annual increase in M1 has been 10.1% whilst M2 has averaged 23.2%. These rates of monetary growth are high by the standards of most OECD economies and the question arises whether or not recent increases in the supply of money - official measures for constraint notwithstanding - have already been strong enough to generate rising inflation and reduced trade competitiveness along the lines of the classical model outlined above.

An important feature of the history of monetary developments in Taiwan has been the long established decline in the income velocity of circulation of money. Chart 5 shows Taiwanese income velocity as the ratio of nominal GNP in each year to the average of M1 and M2 in each year since 1952. It is apparent that both lines have a strong downward trend, showing that the demand for money per unit of output in Taiwan has risen fairly steadily and strongly over a long period of time. It is this trend reduction in the income velocity of both M1 and M2, in an economy which has exhibited a solid real growth record which allows for the possibility that relatively rapid growth in the money supply need not be associated with rising inflation. In a previous article on Taiwan (AMM Vol. 2 No. 4) it was estimated that, for data based on the period 1952-1977, the expected rate of change in the income velocity of M1 was negative 5.09% per annum, and for M2 was negative 8.69%.

Over the last two decades, the average annual increase in real per capita incomes in Taiwan has averaged approximately 8%. This trend increase in real growth combined with the trend reduction in the income velocity of circulation suggests that an appropriate (i.e. non-inflationary) rate of monetary growth in Taiwan might be around 13% for M1 and approximately 16% for M2.

On this basis the recent growth in M2 does appear to be mildly excessive and if it is sustained would likely to lead to inflation in the 5%-10% range over the next couple of years. However, measured inflation towards the lower end of this range (which seems the more probable given the recent comparatively restrained growth in M1) is unlikely seriously to impair Taiwan's trade competitiveness. If we are correct in thinking that Taiwan's inflation rate will remain comparatively modest over the next year to eighteen months then domestic pressures for a cyclical slowdown in the local economy are likely to remain in abeyance. This contrasts with many previous cyclical recoveries in Taiwan where a recovery in exports and an improvement in the external account were generally swiftly followed by double-digit rates of inflation.

FORECAST: In February 1980, Taiwan's membership of the International Monetary Fund was terminated. This coincided with the People's Republic of China's entry to the Fund. The termination of Taiwan's membership of the International Monetary Fund may have encouraged domestic policy makers deliberately to try to enlarge their economy's holdings of International Reserves for prudential reasons.

However, the large increase in Taiwan's current account and overall balance of payments surplus has threatened to precipitate a sharp increase in domestic monetary growth thereby risking higher inflation. The Taiwanese monetary authorities have sought to reduce this risk by offsetting the expansionary impact of rising International Reserves on the growth of the monetary base. By reducing its net credit to both the commercial banks and to the government, the Central Bank of China has hoped to restrict M2 growth to 15% in 1984. However this attempt to control the domestic money supply whilst simultaneously pegging the external value of the N.T. dollar places the Central Bank of China in the uneasy position of attempting to control both the quantity of money and its prices. One may therefore predict confidently that either the authorities will lose control of the quantity of money or that they will again be forced to adjust the external value of the exchange rate.

To the extent that the Taiwanese authorities allow - or, as now, are obliged to accept - above "target" monetary growth the likelihood of a large adjustment in the external value of the N.T. dollar over the short to medium term is reduced. However, we have argued above that the comparatively rapid rates of monetary growth recorded over the last two to three years need not necessarily be associated with a strong rise in inflation. Thus, at present rates of monetary growth, the Central Bank of China's measures to offset the expansionary monetary impact of Taiwan's huge current account surpluses are likely to be moderately successful in maintaining Taiwan's trade competitiveness. However, this implies that the Central Bank of China's problems in restraining domestic monetary growth are likely to multiply: if, as is likely, the world economy continues firm during 1985 Taiwan's current account surplus will expand further thereby creating additional upward pressure on domestic monetary growth. If the Taiwanese authorities are serious in their stated policy to restrict inflation any further rise in Taiwan's current account surplus is likely ultimately to be associated with a substantial revaluation of the N.T. dollar.

THAILAND

DEVALUATION PAVES THE WAY FOR MORE RAPID MONEY GROWTH

On November 2nd the Finance Ministry of Thailand announced a 14.8% devaluation of the Thai Baht and a move to a more flexible exchange rate regime, ending a period of over three years during which the Baht had been rigidly pegged to the US dollar, at a rate of US\$1 = Baht 23. At the opening of trading on Monday, November 5 the Baht was pegged at a rate of US\$1 = Baht 27, but has since fluctuated in a narrow range between US\$1 = Baht 26.80 and US\$1 = Baht 27.02. The Bank of Thailand has stated that it is now linking the Baht to a basket of currencies comprising the US dollar, yen, Deutschmark, sterling and the Malaysian, Hong Kong and Singapore dollars, but will allow the value of the Thai currency to vary against this basket in so far as is warranted or made necessary by domestic economic or international financial considerations.

The devaluation, which was the largest in Thai financial history, came as a complete shock to the political, military and financial communities in Thailand, where the exchange rate is a highly sensitive political issue that has usually been considered an object, rather than an instrument, of monetary policy. Consequently, it was not surprising that the devaluation, which followed the controversial replacement of Nukul Prachuabmoh by Kamchorn Sathirakul as head of the Central Bank in September, provoked strong criticism from both the political opposition and the military, and threatened for a while to plunge the country into a political crisis. Largely to deflect criticism that the devaluation will lead to a sharp rise in prices, the government has taken various measures, such as subsidizing domestic oil prices and cutting import taxes, in an attempt to reduce the immediate impact of the devaluation on domestic price levels.

An AMM article in April (AMM Vol. 8 No. 2) pointed out that the combination of monetary arrangements in existence at that time - credit controls, interest rate ceilings and a fixed exchange rate - was unsustainable, particularly in an economy exposed to large and variable international capital movements, and that eventually the Thai authorities would be under pressure to either introduce controls on foreign exchange flows or move in the other direction, removing controls and floating the exchange rate.

In the event it is clear that, whether by accident or design, they have taken the second option, moving to a regime which gives the Central Bank greater flexibility to control money growth. The 18% per annum ceiling on the growth rate of commercial bank credit was removed in August, having been previously somewhat de-emphasised in June, when the Bank of Thailand adopted a more flexible approach to the implementation of credit controls. Furthermore, interest rates have tended to become less 'sticky' as the psychology in Thai banking and financial management has been changing to one of more flexibility to adapt to the volatile world environment. Commercial banks have actively discouraged the bunching of deposits in maturities of one or two years (making it easier for them to lower interest rates without a squeeze on margins) and the Finance Ministry's move, in March, to equalise the interest rate ceiling on all deposits of between three months and two years maturity has helped in this respect (AMM Vol. 8 No. 2). The introduction of greater flexibility in exchange rate management could therefore be seen as a further step which could, potentially, go some way to freeing the Thai economy from the influence of the world financial environment and, particularly, US financial policy.

However, in practice it remains to be seen how flexible the new exchange rate regime will prove to be. Although the Baht is now linked to a basket of seven currencies including the US dollar, it must be noted that one of those currencies - the Hong Kong

dollar - is effectively pegged to the US unit and two of them - the Singapore and Malaysian dollars - are managed in a very narrow range against it. Furthermore, the weighting given to sterling in the basket is likely to be very low, as the United Kingdom is not a major trading partner of Thailand (Sterling is not a component of AMM's real effective exchange rate index for the Thai Baht). Japan is Thailand's major trading partner and hence the yen is likely to be accorded a high weight in the index. However, although free-floating, over the last two years the yen has also tended to move in a narrow range against the US dollar.

The result is that under the new regime the Baht is likely to trade in a narrow range against the US dollar except in so far as the Bank of Thailand exercises discretion to vary the Baht's value against the basket. It seems likely that, at least in the early period of operation of the new scheme and given the political constraints, such discretion as is exercised by the Bank of Thailand in managing the Baht's value will be aimed in the direction of narrowing further its trading range against the US dollar.

Nevertheless, the introduction of greater exchange rate flexibility will be a further element tending to weaken the linkages between monetary conditions in Thailand and overseas, particularly US, interest rates. The chain of causation running from, firstly, US interest rates and the interest rate differential between the US and Thailand through the links between interest rate differentials and private net foreign borrowing, private net foreign borrowing and the balance of payments, to money growth (illustrated in Charts 1, 2 and 3) has been used extensively in past issues of AMM to analyse monetary conditions in Thailand. The links in the chain have now been weakened at every stage of the process by, firstly, the gradual tendency for interest rates in Thailand to become slightly less rigid, secondly the emerging trend, evident over the past year, for large borrowers to borrow in currencies other than the US dollar and, now, the introduction of some exchange rate risk for potential overseas borrowers, and, thirdly, the perhaps marginal reduction in the necessity of the Bank of Thailand standing ready to defend any given exchange rate for the Baht.

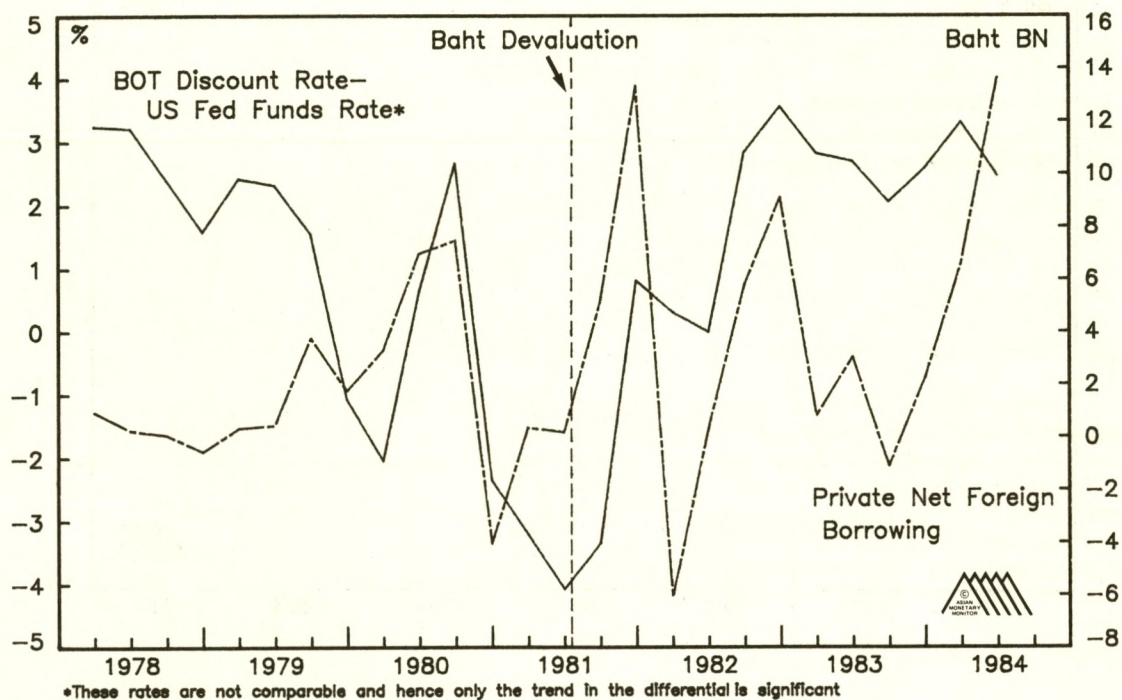
Nevertheless, the new exchange rate regime in Thailand is far from a free float and hence the balance of payments position is likely to remain the critical determinant of the trend in money growth. The recent devaluation should therefore be seen in this light, the obvious conclusion to be drawn being that the devaluation should lead to a period of more rapid money growth.

The reason for the Baht devaluation was to eliminate the supposed over-valuation of the Thai currency and thus help to correct the burgeoning trade deficit. In fact although the Baht, having been fixed to the US dollar, has appreciated enormously against most world currencies over the last three years it does not appear to have been overvalued on either a purchasing power parity or real effective exchange rate (Chart 4) basis before the devaluation. Nevertheless, it cannot be denied that the relative strength of the Baht, when taken together with very weak prices for agricultural products, has posed serious problems for the agricultural sector. The timing of the devaluation is supposed to be appropriate to benefit the farming community in that it was instituted just before the December to March annual export crop season.

The timing of the devaluation was certainly 'good' in so far as the move was taken when there was a complete absence of speculative pressure against the Baht. If the authorities had devalued early in the year, when the Baht was under intense speculative pressure, then the management of the new exchange rate regime would have been made that much more difficult. However, the question of whether or not the decision to devalue was 'right' or 'wrong' will probably only be answerable fully with the benefit of hindsight. Much obviously depends upon developments in the US economy and the behaviour of the US dollar. In this respect, it was odd that the Thai authorities took the decision to devalue at a time when the dollar was weakening and US interest rates were trending downwards.

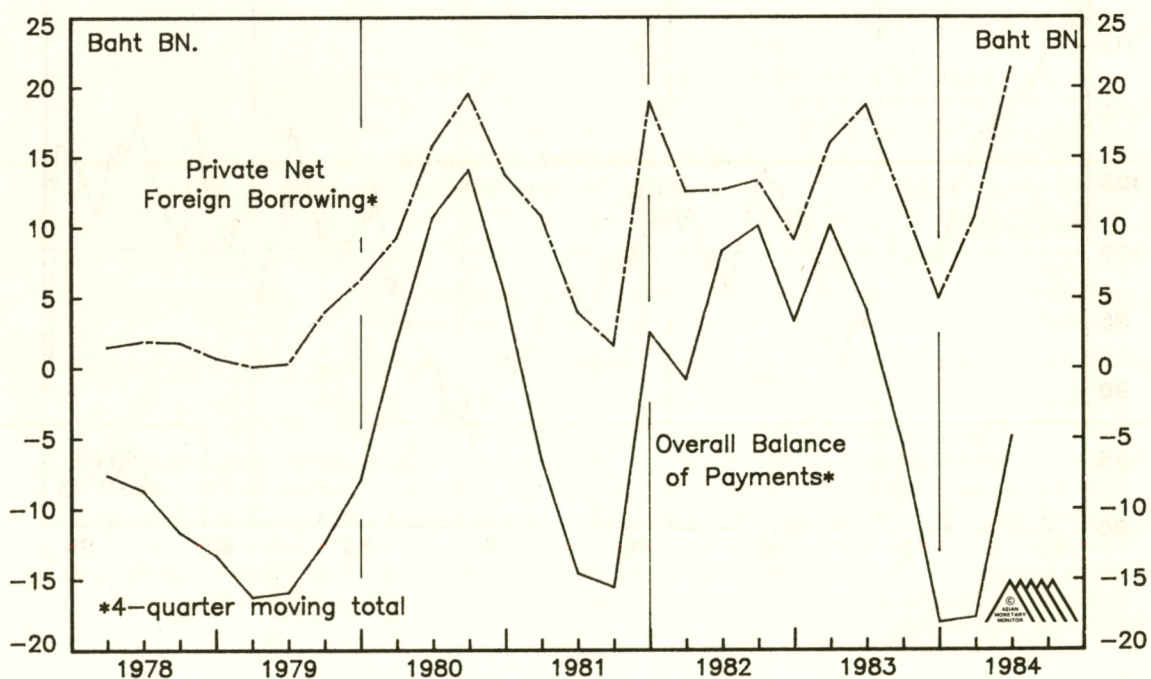
THAILAND

CHART 1: INTEREST RATES AND PRIVATE NET FOREIGN BORROWING



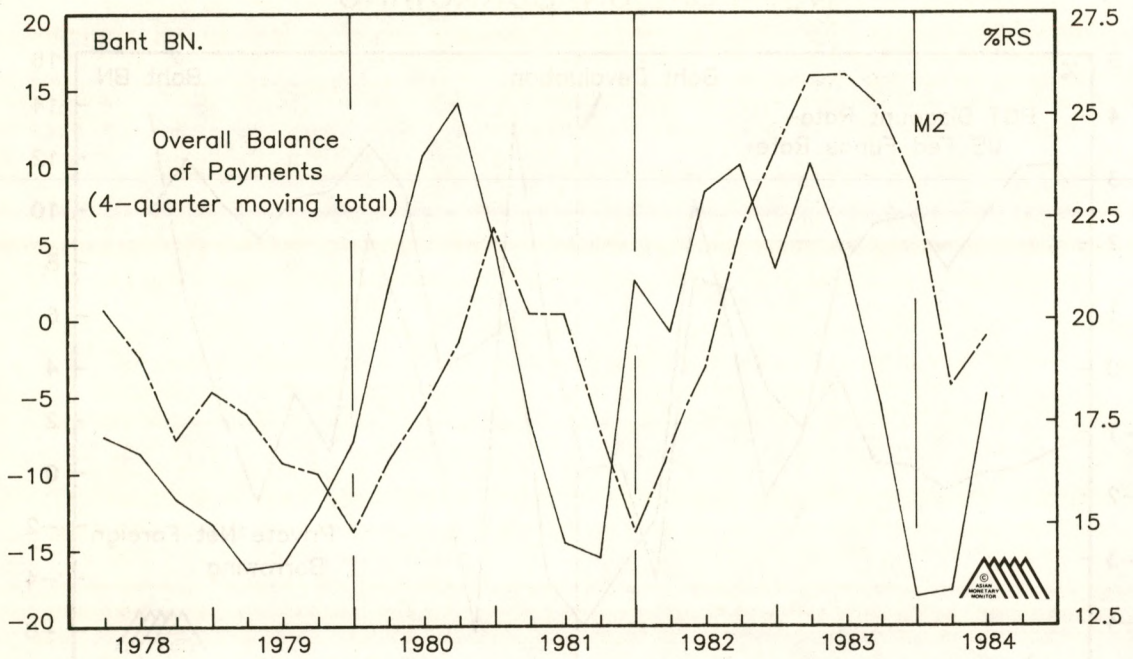
THAILAND

CHART 2: PRIVATE NET FOREIGN BORROWING AND THE BALANCE OF PAYMENTS

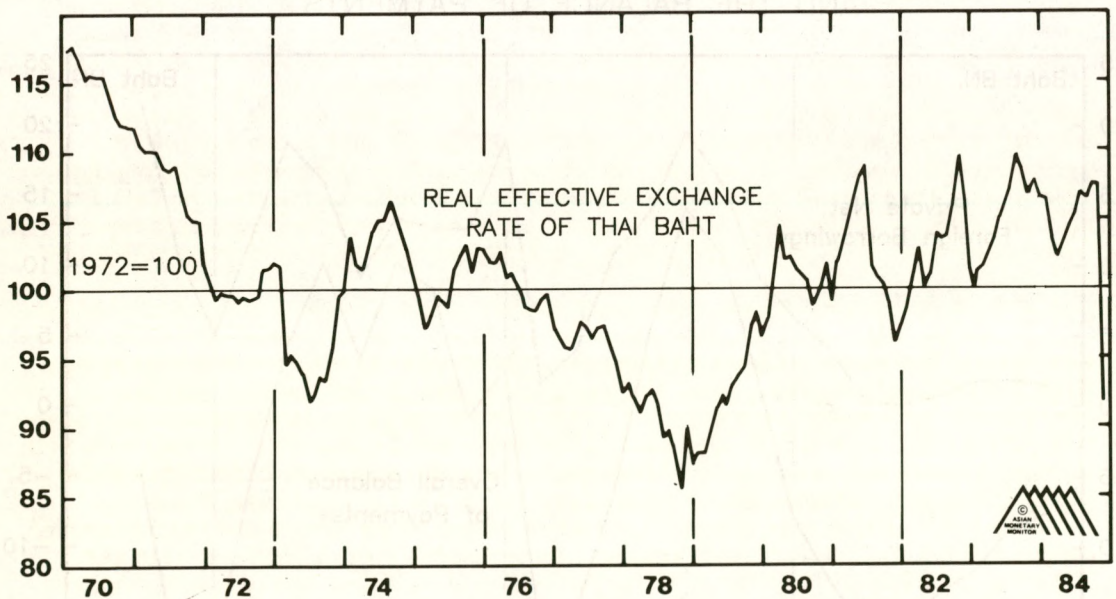


THAILAND

CHART 3: THE BALANCE OF PAYMENTS AND MONEY GROWTH



THAILAND: CHART 4 REAL EFFECTIVE EXCHANGE RATE OF THAI BAHT



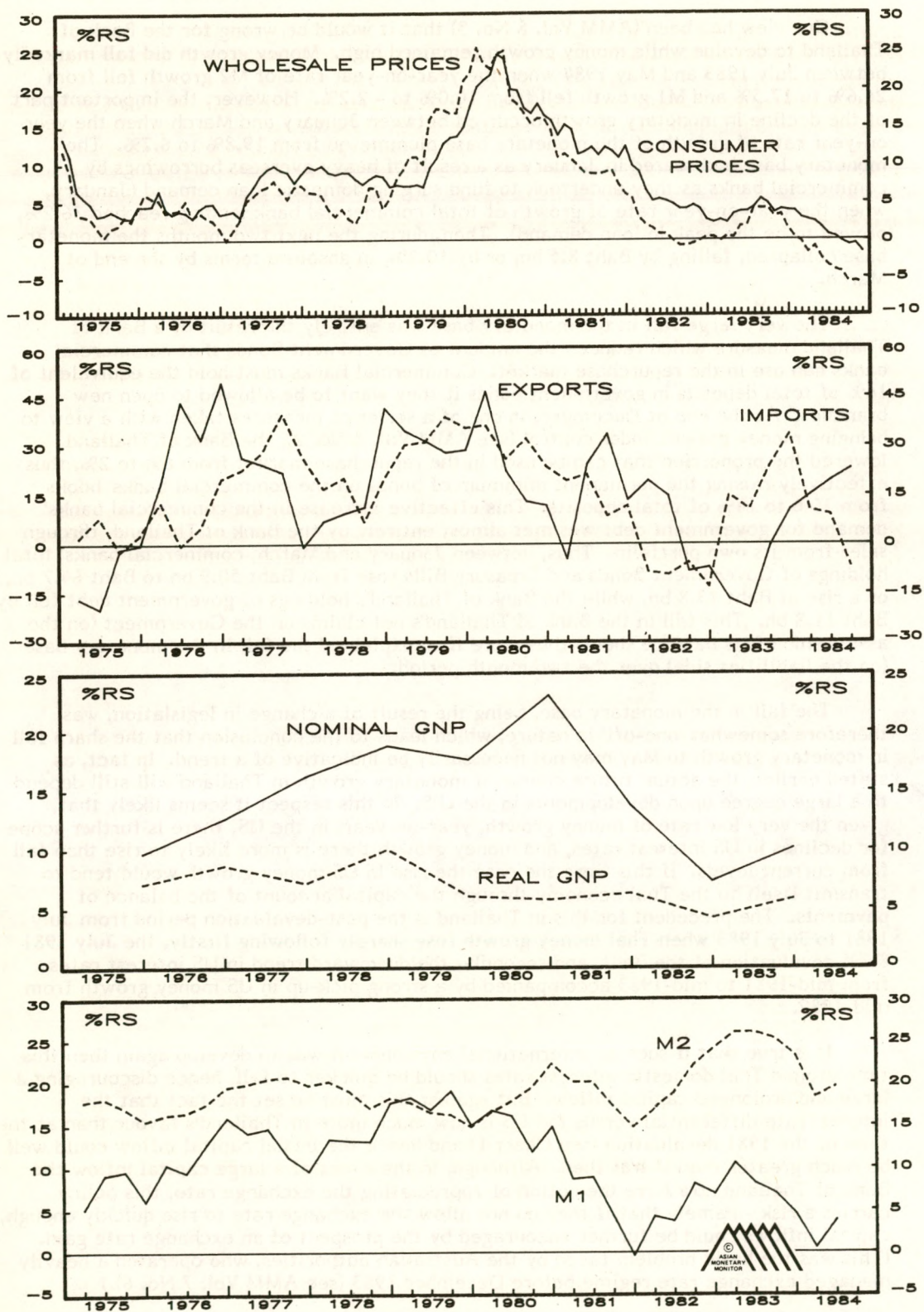
Our view had been (AMM Vol. 8 No. 3) that it would be wrong for the Bank of Thailand to devalue while money growth remained high. Money growth did fall markedly between July 1983 and May 1984 when the year-on-year rate of M2 growth fell from 26.6% to 17.5% and M1 growth fell from 10.0% to - 2.2%. However, the important part of the decline in monetary growth occurred between January and March when the year-on-year rate of growth of the monetary base plummeted from 19.8% to 6.2%. The monetary base had soared in January as a result of heavy overseas borrowings by commercial banks as they undertook to fund surging domestic loan demand (January, when the year-on-year rate of growth of total commercial bank lending reached 36.2%, proved to be the peak in loan demand). Then, during the next two months the monetary base collapsed, falling by Baht 8.5 bn, or by 10.2%, in absolute terms by the end of March.

The very large fall in the monetary base was entirely the result of a Bank of Thailand measure which reduced the amount of Government Bonds that commercial banks can use in the repurchase market. Commercial Banks must hold the equivalent of 16% of total deposits in government bonds if they want to be allowed to open new branches. At the end of December, in one of a series of measures taken with a view to bringing money growth under control (see AMM Vol. 8 No. 2), the Bank of Thailand lowered the proportion that can be used in the repurchase market from 6% to 2%, thus effectively raising the permanent minimum of bonds on the commercial banks' books from 10% to 14% of total deposits. This effective increase in the commercial banks' demand for government debt was met almost entirely by the Bank of Thailand, through sales from its own portfolio. Thus, between January and March, commercial banks' total holdings of Government Bonds and Treasury Bills rose from Baht 50.9 bn to Baht 64.7 bn, or a rise of Baht 13.8 bn, while the Bank of Thailand's holdings of government debt fell by Baht 11.8 bn. This fall in the Bank of Thailand's net claims on the Government (on the assets side of its balance sheet) thus more than explained the fall in the monetary base (on the liabilities side) over the two month period.

The fall in the monetary base, being the result of a change in legislation, was therefore somewhat 'one-off' in nature, which leads to the conclusion that the sharp fall in monetary growth to May may not necessarily be indicative of a trend. In fact, as stated earlier, the actual future course of monetary growth in Thailand will still depend to a large degree upon developments in the U.S. In this respect it seems likely that, given the very low rate of money growth, year-on-year, in the US, there is further scope for declines in US interest rates, and money growth there is more likely to rise than fall from current levels. If this were the case the rise in US money growth would tend to transmit itself to the Thai economy through the capital account of the balance of payments. The precedent for this in Thailand is the post-devaluation period from July 1981 to July 1983 when Thai money growth rose sharply following firstly, the July 1981 8.7% devaluation of the Baht, and secondly, the downward trend in US interest rates from mid-1981 to mid-1983 accompanied by a strong pick-up in US money growth from mid-1982.

It is true that if such an international environment was to develop again then this time around Thai domestic interest rates should be quicker to fall, hence discouraging a large and prolonged capital inflow. But against this must be set the fact that the interest rate differential versus the US is now much more in Thailand's favour than at the time of the 1981 devaluation (see Chart 1) and hence the initial capital inflow could well be much greater than it was then. Although, in the event of a large capital inflow the Bank of Thailand now have the option of appreciating the exchange rate, this policy carries a risk - namely that if they do not allow the exchange rate to rise quickly enough, capital inflows could be further encouraged by the prospect of an exchange rate gain. (This was the basic problem faced by the Australian authorities, who operated a heavily managed exchange rate regime before December 1983 (see AMM Vol. 7 No. 6).)

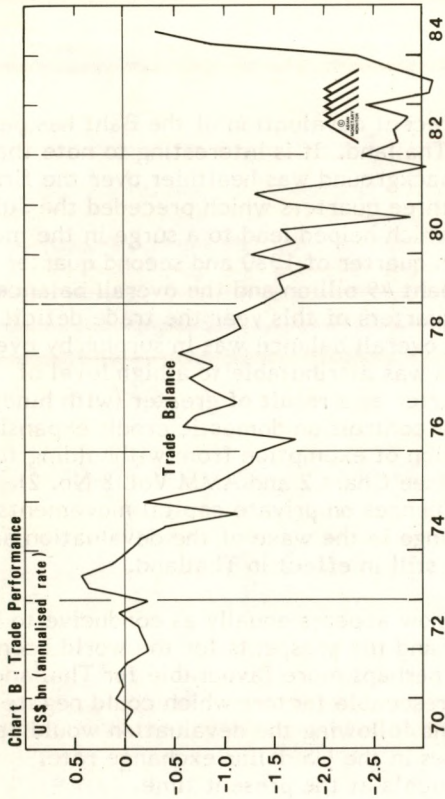
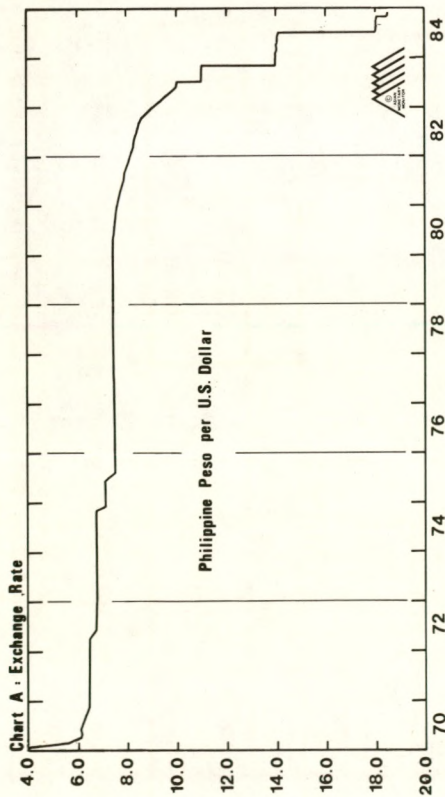
THAILAND: CHART 5
MONEY, OUTPUT, PRICES AND TRADE



FORECAST: The conclusion must be that the recent devaluation of the Baht has paved the way for a return to rapid money growth in Thailand. It is interesting to note that, perhaps surprisingly, the balance of payments background was healthier over the first three quarters of this year than it was for the three quarters which preceded the July 1981 devaluation, a much smaller devaluation which helped lead to a surge in the money growth rate. For the period between the fourth quarter of 1980 and second quarter of 1981 the Thai trade account was in deficit by Baht 49 billion and the overall balance in deficit by Baht 14 billion. For the first three quarters of this year the trade deficit was of similar magnitude - Baht 52 billion - but the overall balance was in surplus by over Baht 4 billion. The balance of payments surplus was attributable to a high level of private net foreign borrowing in the second quarter as a result of greater (with hindsight, misplaced) confidence in the exchange rate, the controls on domestic credit expansion and the imminent (at the end of June) termination of exemption from withholding tax for foreign borrowings of over two years maturity (see Chart 2 and AMM Vol. 8 No. 2). Although these factors do not now apply as influences on private capital movements, there is little reason to expect the trend to change in the wake of the devaluation and given the relatively high level of interest rates still in effect in Thailand.

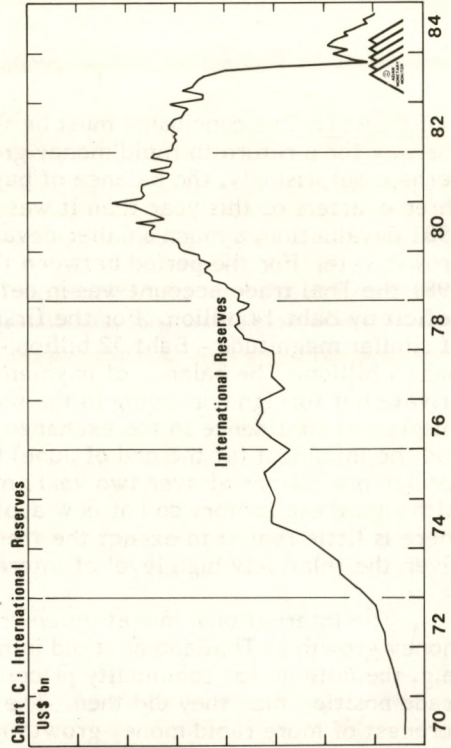
The international monetary environment now appears equally as conducive to high money growth in Thailand as it did in mid-1981 and the prospects for the world economy (e.g. the outlook for commodity prices) appear perhaps more favourable for Thailand's trade position than they did then. The main foreseeable factors which could negate a forecast of more rapid money growth in Thailand following the devaluation would be a tightening of US monetary policy or further rises in the US dollar exchange rate. However, neither of these seem likely developments at the present time.

PHILIPPINE PESO



Since June 1983 the Philippine peso has almost halved in value against the US Dollar. On June 5 this year the Philippine authorities announced a series of austerity measures (including a rise in the import surcharge from 8% to 10%, a 5% cut in the national budget and a 'windfall profits' tax on exporters) which included the third devaluation of the peso in the space of a year. The value of the Philippine currency was lowered by 22.2%, from US\$1 = P14 TO US\$1 = P18. The rate of US\$1 = P18 was to be available only to importers of merchandise goods, however, purchasers of foreign exchange for other uses having to pay a 10% tax to put the effective exchange rate at US\$1 = P19.8.

New arrangements adopted on June 5 theoretically involved floating the peso but strict controls on foreign exchange transactions (commercial banks were still required to turn over 80% of foreign exchange receipts to the Central Bank) and exchange rate management by the Central Bank kept the peso at the US\$1 = P18 rate until October. From October 2, following the reaching of an initial agreement with the IMF, the Central Bank allowed the peso to slip further downwards. Then, after the October 13 acceptance of the Philippines' letter of intent to the IMF, foreign exchange controls and other limitations on peso trading were lifted, with the result that the peso fell to its current level of around 20 to the US Dollar. To meet IMF requirements the government also took other measures at that time, which included cuts in import duties and foreign exchange taxes as well as the lifting of some price controls.



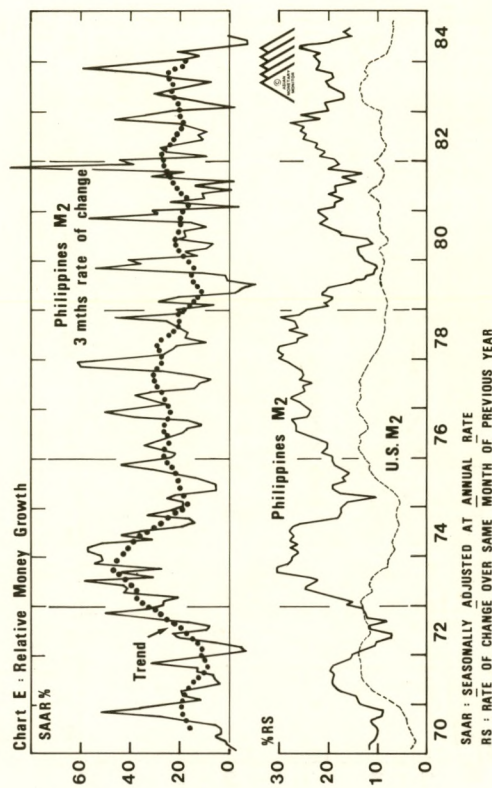
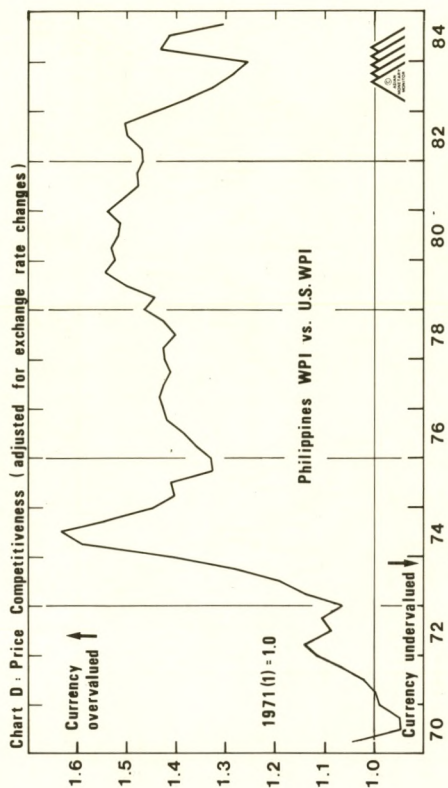
The Philippines has been in a state of economic crisis evident since October 1983 when it reported that its foreign exchange reserves had been almost totally depleted. Negotiations with the IMF and commercial bank creditors for debt rescheduling and new borrowings dragged on for a year as the Central Bank proved unable to cope with an exploding money supply and spiralling inflation. By July year-on-year M1 growth had reached 54.0% and consumer price inflation, 56.4%. Central Bank attempts to rein in monetary growth were thwarted by credit extensions to the Government (particularly during the campaign run-up to the National Assembly elections in May) and to distressed financial institutions, forced upon it either by necessity or (in the case of Banco Filipino in July) by the order of President Marcos. The increase in Central Bank net credit extension to distressed financial institutions can, on its own, 'explain' the 87.6% growth in the monetary base (unadjusted for increases in reserve requirements) for the year to July.

The Philippine economy contracted by 5.2% (in peso terms) during the first nine months of the year. The collapse in imports resulting from the acute shortage of foreign exchange has led to a substantial improvement in the trade balance (see Chart B). Although the Philippines' international reserve holdings have now fallen to a new low level (see Chart C), now that agreement has been reached on debt rescheduling and new borrowings of US\$630million from the IMF and US\$925 million from commercial banks, further large devaluations of the peso may not be necessary. However, the peso seems likely to continue to drift gradually downwards while the current account of the balance of payments remains in deficit.

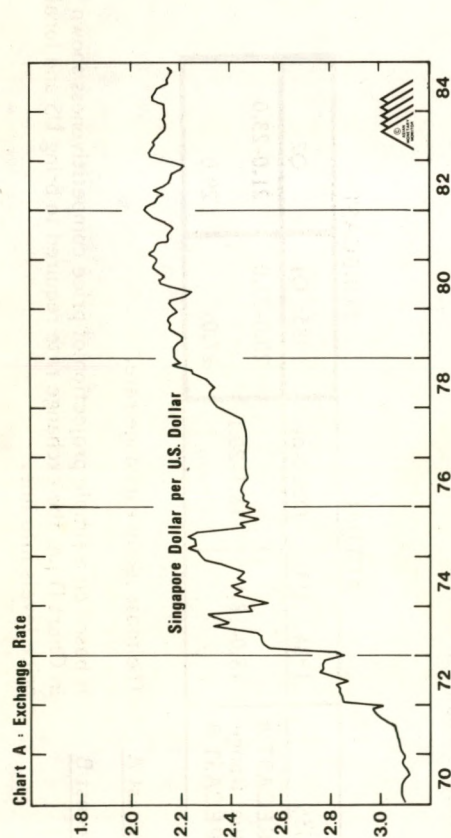
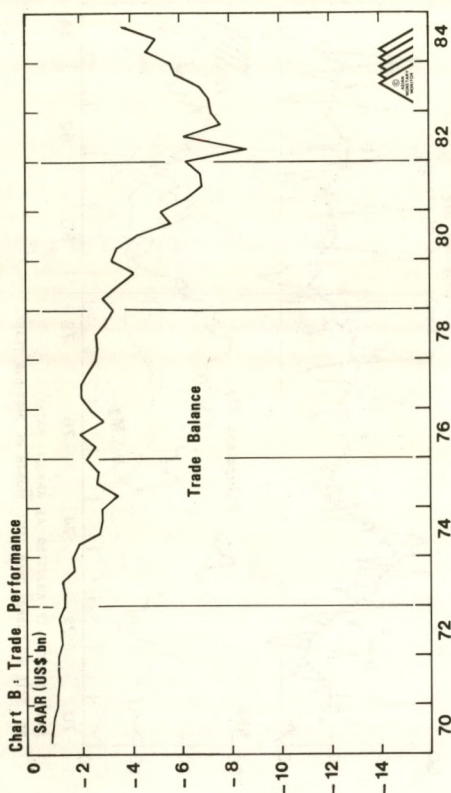
P/US\$	ACTUAL			FORECAST	
	1984	Q3	Oct-Nov	1985 Q1	Q2
FORECAST A					
Actual Range	18.0-18.1		18.1-20.1	20.0-22.0	21.0-23.0
FORECAST B				27.0	29.0

Forecast A The most likely exchange rate.

Forecast B is based on a simple projection of price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line.

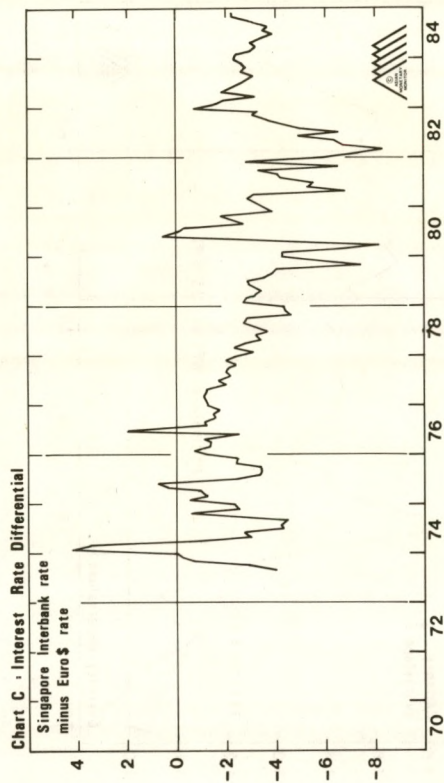


SINGAPORE DOLLAR



The Singapore dollar has remained locked in a very narrow trading range against the US dollar since early 1983. The narrowness of the range, between US\$1 = S\$2.08 and US\$1 = S\$2.17, reflects the management of the exchange rate by the Monetary Authority of Singapore (MAS). The MAS aims to keep the Singapore currency stable primarily against the US dollar, but would also seem to take into consideration the unit's value against the Japanese yen, a currency which has itself remained fairly stable against the US dollar over the past two years.

Currently, the Singapore dollar is at the very bottom of this trading range. In past issues of AMM we have often drawn attention to the fact that a downward drift in the Singapore dollar exchange rate is usually associated with a falling money growth rate because, under Singapore's managed exchange rate regime, both of these factors tend to be symptoms of a deteriorating balance of payments position. During 1984 - or at least up until the time of most recent available statistics (September) - the money supply, on either the M1 or M2 measure, has failed to grow at all on a monthly basis. Consequently, by September the year-on-year growth rates of M1 and M2 had fallen to 1.4% and 8.1% respectively, compared with rates of 7.6% and 12.7% in January (see Chart E). These are extremely low rates of money growth for an economy which is growing at 9% in real terms for the year.



Despite the fact that the Singapore dollar is now at the lower end of its normal range, monetary and financial conditions in Singapore indicate that the exchange rate for the Singapore dollar is still 'too high' at current levels. The falling rate of money growth in Singapore is attributable partly to the highly contractionary influence of the public sector, which runs a large and growing surplus in its fiscal and other operations, and also to some deterioration in the balance of payments position. Although the trade account has sustained a very marked improvement this year (see Chart B) on the back of strong exports to the US, the capital account of the balance of payments - particularly the balance on monetary capital - would appear to have deteriorated. For the eight months between January and September the monetary capital flow into Singapore's commercial banking sector fell to S\$54.3 million, from S\$2,071.2 million in the prior eight month period.

Chart D indicates that the real effective exchange rate for the Singapore dollar is currently some 15% higher than it was during the late 1970's. If money growth in Singapore is to return to levels which will enable economic growth to be sustained, then the MAS should depreciate the Singapore dollar and expand the monetary base. It is possible that they may be 'let off the hook' by either sharply lower interest rates in the US, or a markedly weaker US dollar, or both. Otherwise, the recent devaluations of other ASEAN currencies and, perhaps, lower oil prices (which could be expected to put pressure on the Indonesian Rupiah and the Malaysian Ringgit) might provide the MAS with an excuse to lower the Singapore dollar's value.

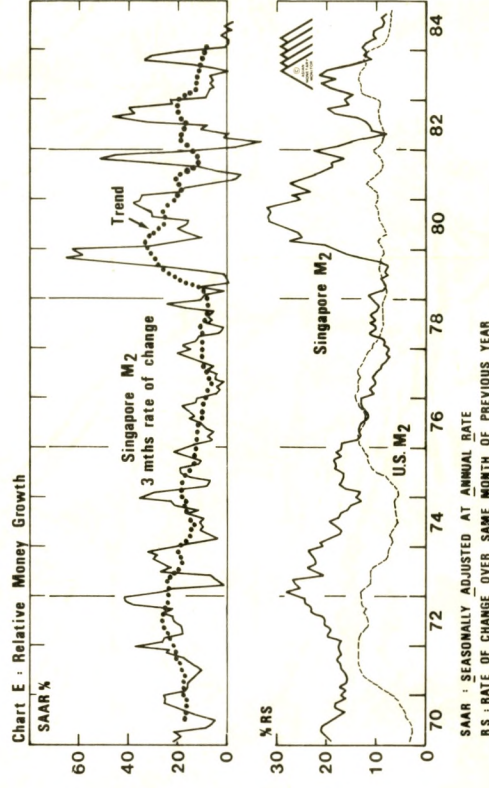
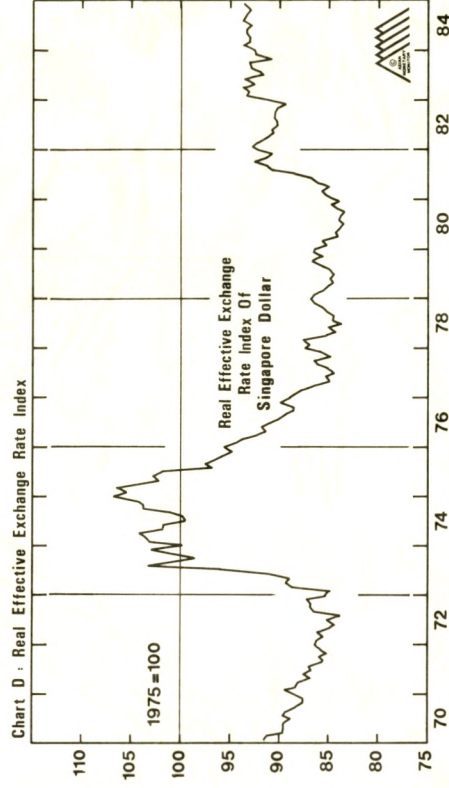
S\$/US\$	ACTUAL		FORECAST	
	1984	Q3 Oct.-Nov.	1985 Q1	Q2
FORECAST A			2.15-2.25	2.20-2.35
Actual Range	2.1375-2.1715	2.1445-2.1718		
FORECAST B			2.14-2.18	2.10-2.18

Forecast A

assumes that US interest rates remain at or near current levels and that the US dollar remains generally firm as a consequence.

Forecast B

assumes that US interest rates decline markedly into 1985, and that there is some weakening of the US dollar as a result.





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